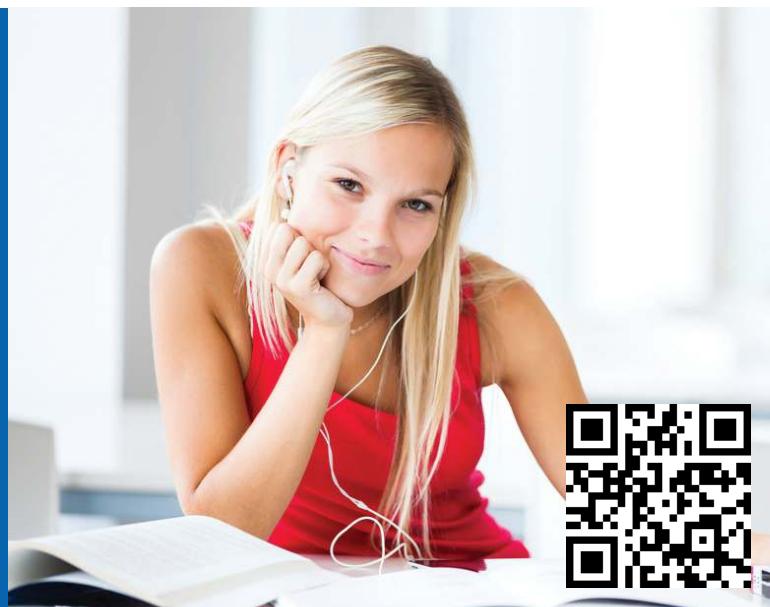


Financial Reporting (FR)

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ACCA Financial Reporting (FR)

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CONCEPTUAL AND REGULATORY FRAMEWORK

Chapter 1

IASB CONCEPTUAL FRAMEWORK

The IASB Framework provides the underlying rules, conventions and definitions that underpin the preparation of all financial statements prepared under International Financial Reporting Standards (IFRS).

- Ensures standards developed within a conceptual framework
- Provide guidance on areas where no standard exists
- Aids process to improve existing standards
- Ensures financial statements contain information that is useful to users
- Helps prevent creative accounting

The revised IASB Conceptual Framework was issued in March 2018 and the new areas included are as follows:

- Measurement basis
- Presentation and disclosure
- Derecognition

Whilst **updates** have been made to the following:

- Definitions of assets/liabilities
- Recognition of assets/liabilities

And **clarification** on:

- Measurement uncertainty
- Prudence
- Stewardship
- Substance over form



1. Objective of financial reporting

'Provide information that is useful to existing and potential investors, lenders and other creditors in making **decisions** about providing resources to the entity'

The decisions made by **users** will involve:

- Investment decisions
- Financing decisions
- Voting, or influencing management actions

The users will be assessing the management's stewardship of the entity alongside its prospects for the future, which will require the following information:

- Economic resources of the entity
- Claims against the entity
- Changes in the entity's economic resources and claims.
- Efficiency and effectiveness of management

2. Qualitative characteristics – make information useful

Fundamental qualitative characteristics

- Relevance – information that makes a difference to decisions made by users (nature and materiality)
- Faithful information – must faithfully represent the substance of what it represents, and is therefore complete (helps understand and includes descriptions and explanations), neutral (no bias, and therefore supported by the exercise of prudence) and free from error. Measurement uncertainty will impact the level of faithful representation.

Enhancing qualitative characteristics

- Comparability – identify similarities/differences between entities and year-on-year
- Verifiability – assures the information represents the economic phenomena it represents
- Timeliness – information is less useful the longer it takes to report it
- Understandability – user have a reasonable knowledge of business and activities

A cost constraint applies in ensuring that the information is useful, in that the benefit of obtaining the information should outweigh the cost of obtaining it.



3. Financial statements and the reporting entity

Reporting entity

Is the entity that is required to prepare financial statements and does not necessarily have to be a legal entity.

Financial statements

Report the entities assets, liabilities, income and expenses for:

- Consolidated financial statements
- Un-consolidated financial statements
- Combined financial statements
 - ▶ Prepared for the entity as a whole
 - ▶ Entity is a going concern and will continue to do so

4. Elements of financial statements

- **Assets**
 - ▶ Present economic resource
 - ▶ Controlled
 - ▶ Past events
- **Liabilities**
 - ▶ Present obligation
 - ▶ Transfer an economic resource
 - ▶ Past event
- **Equity**
 - ▶ Residual interest in assets less liabilities
- **Income**
 - ▶ Increase in asset
 - ▶ Reduction in liability
- **Expense**
 - ▶ Reduction in asset
 - ▶ Increase in liability

5. Recognition and derecognition

Recognition – the process of including an item in the financial statements and is appropriate if it results in relevant and faithful representation

Derecognition – the removal of all or part of an asset (loss of control)/liability (no obligation)



6. Measurement

Historical cost

Price of the transaction that gave rise to the item

Current value

Provides updated information to reflect conditions at the measurement date

- Fair value
- Value in use (assets)/Fulfilment value (liabilities)
- Current cost

7. Presentation and disclosure

Statement of profit or loss is the primary source of information for a company's performance, which includes all income and expense. If the income and expense arises from changes in current value then it can be recognised through other comprehensive income.

Reclassification of other comprehensive to profit or loss is allowable if it gives more relevant information.

8. Capital maintenance

- Financial capital maintenance
- Operating (physical) capital maintenance

Example 1 – Qualitative characteristics

The IASB's Conceptual Framework for Financial Reporting identifies characteristics which make financial information faithfully represent what it purports to represent.

Which of the following are examples of those characteristics?

1. Accruals
2. Completeness
3. Going concern
4. Neutrality

A (1) and (2)
B (2) and (4)
C (2) and (3)
D (1) and (4)



Example 2 - Framework

The following accounting standards were examined in Financial Accounting:

- IAS 2 Inventories
- IAS 16 Property, plant and equipment

Apply the principles outlined in the IASB Framework to the accounting standards above.

Example 3 - Measurement

In a country where the economy is growing and prices are subject to regular increases, which of the following are false when using historical cost accounting compared to current value accounting?

- Historical cost profits are understated in comparison to current value profits
- Capital employed which is calculated using historical cost is understated compared to current value capital employed
- Historical cost profits are overstated in comparison to current value profits
- Capital employed which is calculated using historical costs is overstated compared to current value capital employed

A (1) and (2)
B (1) and (4)
C (2) and (3)
D (2) and (4)

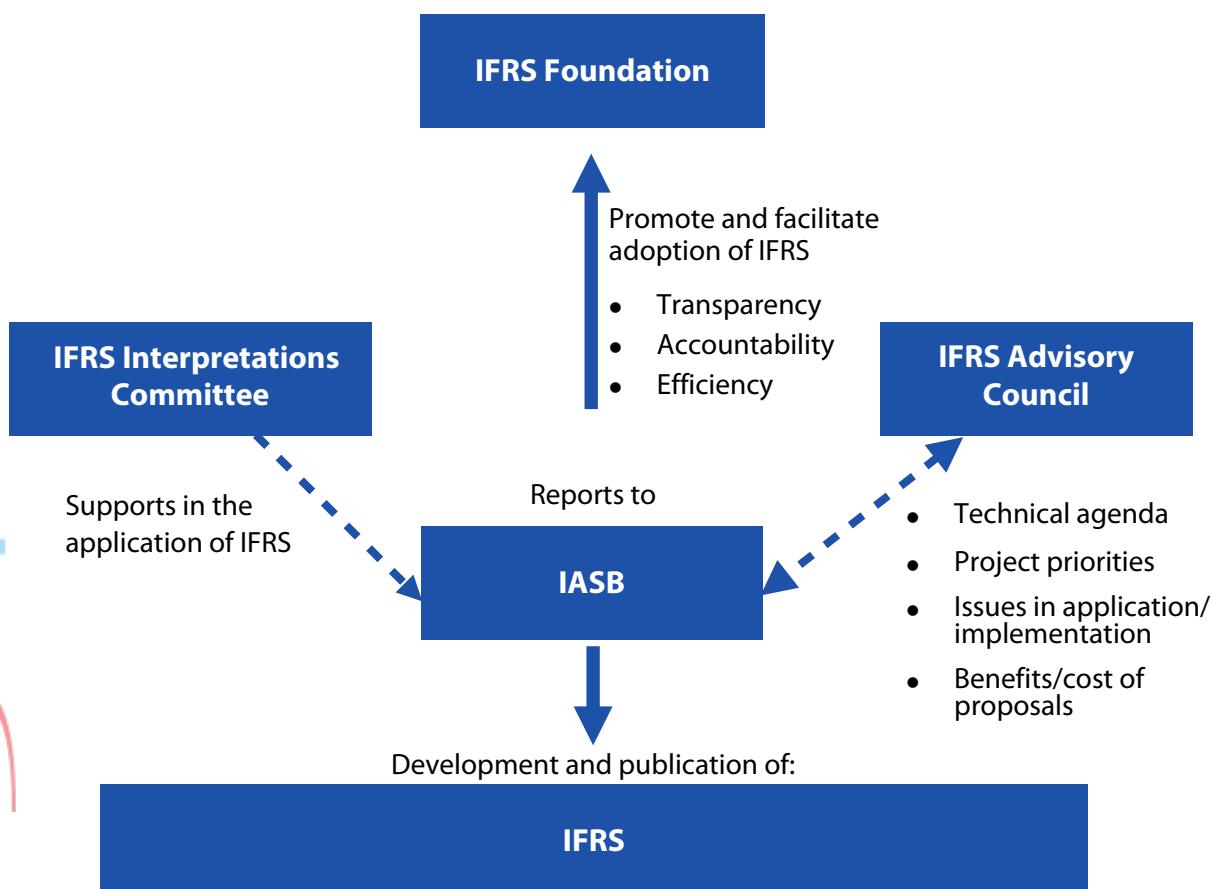




Chapter 2

REGULATORY FRAMEWORK

A regulatory framework exists to ensure that the accounting standards are prepared to meet the needs of users.



<http://www.ifrs.org/about-us/who-we-are/>

Example 1 - Regulatory Framework

Which one of the following is a duty of the IFRS Interpretations Committee?

- A To provide guidance on financial reporting issues not specifically addressed in IFRSs
- B To develop and approve IFRSs
- C To gather views that supplement the normal consultative process
- D To promote the use and rigorous application of IFRSs



Example 2 – Regulatory bodies

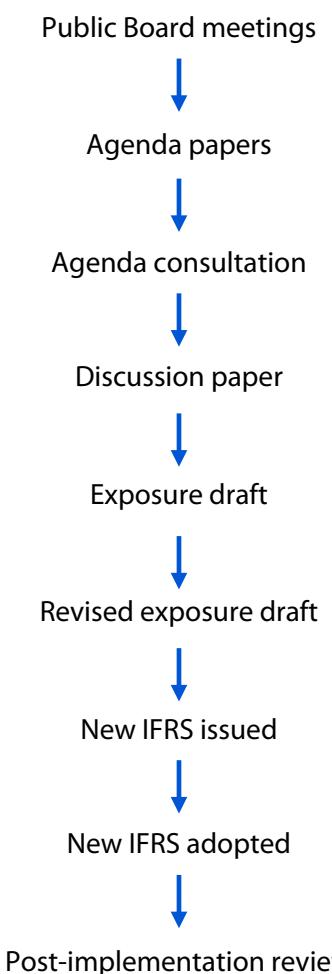
Which one of the following would NOT be regarded as a responsibility of the IASB?

- A Responsible for all IFRS technical matters
- B Publish IFRSs
- C Overall supervisory body of the IFRS organisations
- D Final approval of interpretations by the IFRS Interpretations Committee

1. IASB work plan

Technical projects (e.g. revenue/leases/financial instruments) are all set out in the work plan (<http://www.ifrs.org/projects/work-plan/>), however it does not include just standard setting projects. It also includes research (evidence gathering) and maintenance (narrow scope amendments and interpretations) projects.

2. Standard setting process



PUBLISHED COMPANY ACCOUNTS

Chapter 3

PRESENTATION OF FINANCIAL STATEMENTS (IAS 1)

The purpose of IAS 1 (revised) is to ensure greater clarity and understandability of financial statements.

Financial statements will present to the users of accounts:

- Statement of financial position
- Statement of profit or loss and other comprehensive income
- Statement of changes in equity
- Statement of cash flows
- Notes to the accounts (accounting policies and explanations)
- Comparatives

Financial statements should provide a fair presentation of the results, which is achieved by compliance with IFRSs.

Additionally, the entity should also disclose the following to make the financial statements more understandable:

- The name of the reporting entity
- Whether the financial statements are the individual or group financial statements
- The reporting date and the period covered by the financial statements
- The presentation currency
- The level of rounding used in presenting the amounts within the financial statements



Statement of financial position as at [date]

	\$'000s	\$'000s
ASSETS		
<i>Non-current assets</i>		
Property, plant and equipment		X
Intangibles		X
Financial assets		X
		<hr/>
<i>Current assets</i>		
Inventories		X
Trade and other receivables		X
Financial assets		X
Cash and cash equivalents		X
		<hr/>
Non-current assets held for sale		X
		<hr/>
<i>Total assets</i>		X
		<hr/>
EQUITY AND LIABILITIES		
<i>Equity</i>		
Equity shares (\$1)		X
Retained earnings		X
Other components of equity		X
Total equity		X
		<hr/>
<i>Non-current liabilities</i>		
Long term borrowings		X
Deferred tax		X
		<hr/>
<i>Current liabilities</i>		
Trade and other payables		X
Dividends payable		X
Tax payable		X
		<hr/>
<i>Total equity and liabilities</i>		X
		<hr/>



Statement of profit and loss and other comprehensive income for the year ended [date]

Continuing operations	\$'000s
Revenue	X
Cost of sales	(X)
Gross profit	X
Distribution expenses	(X)
Administrative expenses	(X)
Operating profit	X
Finance costs	(X)
Investment income	X
Profit before tax	X
Income tax expense	(X)
Profit from continuing operations for the period	X
Discontinued operations	
Profit/(loss) for the period from discontinued operations	X
Profit/(loss) for the period	X
Other comprehensive income for the year (after tax):	
<i>Items that will not be reclassified to profit or loss:</i>	
Gain on non-current asset revaluations	X
Gain/(loss) on fair value through other comprehensive income investment	X/(X)
Income tax on items that will not be reclassified	X/(X)
Other comprehensive income, net of tax	X
Total comprehensive income for the period	X



Example 1 – Statement of profit and loss, and statement of financial position

You are the accountant of Trott Ltd, a business that buys and sells cricket equipment.

The trial balance at 31 December 2017 was as follows:

	\$	\$
Equity share capital (\$1)		5,000
Retained earnings at 1 January 2017		5,835
Revenue		66,980
Staff costs	5,400	
Inventory at 1 January 2017	3,930	
Purchases	38,760	
Distribution costs	3,130	
Administrative expenses	3,790	
Loan interest	200	
Investment income		250
Tax	200	
Receivables and payables	9,290	2,360
Bank	3,125	
Motor vehicles – cost	5,000	
Buildings – cost	12,000	
Motor vehicles – accumulated depreciation 1 January 2017		1,000
Buildings - accumulated depreciation 1 January 2017		2,400
Debentures (2020)		1,000
	<hr/> 84,825	<hr/> 84,825

Additional information:

1. Trott has not made any additions or disposals of tangible non-current assets in the year. Its depreciation policy is as follows:
 - Motor vehicles – 20% reducing balance
 - Buildings – 25 years straight line
 The depreciation expense for the year is charged to cost of sales.
2. Inventory at the end of the year was valued as follows:

	Cost (\$)	NRV (\$)
Bats	2,500	4,000
Gloves	650	500
Pads	1,000	2,000
Total	<hr/> 4,150	<hr/> 6,500

3. Staff costs are to be apportioned equally across cost of sales, distribution costs and administrative expense.
4. The balance of tax on the tax account represents the over/under provision for the prior year. An estimate of \$1,500 has been made for the tax payable at the year-end.

Prepare in a statement of profit or loss for the year-ended 31 December 2017 and a statement of financial position at that date.



Statement of changes in equity for the year ended [date]

	<i>Equity shares</i>	<i>Retained earnings</i>	<i>Revaluation surplus</i>	<i>Total</i>
	<i>\$'000s</i>	<i>\$'000s</i>	<i>\$'000s</i>	<i>\$'000s</i>
B/f (as previously stated)	X	X	X	X
Change in policy/error	–	X/(X)	–	X/(X)
B/f (restated)	X	X	X	X
Issue of share capital	X	–	–	X
Dividends	–	(X)	–	(X)
Total comprehensive income for the year	–	X	X	X
Transfer to retained earnings	–	X	(X)	–
C/f	X	X	X	X

Example 2 – Statement of changes in equity (1)**Which of the following should appear in a company's statement of changes in equity?**

1. Total comprehensive income for the year
2. Amortisation of capitalised development costs
3. Surplus on revaluation of non-current assets

A 1, 2 and 3
B 2 and 3 only
C 1 and 3 only
D 1 and 2 only



Example 3 – Statement of changes in equity (2)

Extracts from Ball's nominal ledger for the year ended 31 December 2017 are as follows:

	\$'000
Profit for the year	421
Dividend	(98)
	<hr/> 323

During the year the following important events took place:

- (i) Properties were revalued by \$105,000 increase.
- (ii) 200,000 equity shares of \$1 were issued during the year at a 25c premium

The opening equity balances were as follows:

	\$
Issued capital	400,000
Share premium	50,000
Revaluation surplus	165,000
Retained earnings	310,000
	<hr/> 925,000

Prepare the statement of changes in equity for the year-ended 31 December 2017.



Chapter 4

STATEMENT OF CASH FLOWS (IAS 7)

Statement of cash flows for the year ended [date]

	\$'000s	\$'000s
<i>Cash flows from operating activities</i>		
Profit before tax		X
Finance cost		X
Investment income		(X)
Depreciation/amortisation		X
(Profit)/loss on disposal of PPE		(X)/X
Increase in inventory		(X)
Increase in receivables		(X)
Increase in payables		X
Cash generated from operations		X
Interest paid		(X)
Income taxes paid		(X)
Net cash generated from operating activities		X
<i>Cash flows from investing activities</i>		
Proceeds from sale of PPE		X
Purchase of PPE		(X)
Interest received		X
Dividends received		X
Net cash used in investing activities		(X)
<i>Cash flows from financing activities</i>		
Issue of equity shares		X
Repayment of loan-term borrowings		(X)
Proceeds from issue of long-term borrowings		X
Dividend paid		(X)
Net cash generated from financing activities		(X)
Net increase/(decrease) in cash and cash equivalents		X
Cash and cash equivalents at the beginning of the period		X
Cash and cash equivalents at the end of the period		X



Interest paid**Interest payable**

		B/f	X
Bank (β)	X	Finance cost (SPL)	X
C/f	X		
	X		X

Tax paid**Tax payable**

		B/f – current tax	X
		– deferred tax	X
Bank (β)	X	Tax expense (SPL)	X
C/f – current tax	X		
– deferred tax	X		
	X		X

Property, plant and equipment (PPE)**PPE (CV)**

B/f	X	Depreciation	X
Revaluation	X	Disposal	X
Cash - additions (β)	X		
		C/f	X
	X		X

And,

$$\pi/\lambda \text{ on disposal} = \text{Proceeds} \text{ less} \text{ Carrying value}$$



Equity shares

Issue of shares = movement in share capital and share premium

Borrowings

Issue of debt = increase in borrowings

Repayment of debt = decrease in borrowings

Dividend paid

<i>Retained earnings</i>			
	B/f		X
Dividend paid (β)	X	PFY (SPL)	X
C/f	X		
	X		X

Cash and cash equivalents

	B/f	C/f	Movement
Cash	X	X	
Cash equivalents	X	X	
Overdraft	(X)	(X)	
	X	X	X/(X)



4. Approach

1. Read the requirement, noting the year-end date, and allocate the timings
2. Statement of cash flow headings
 - ▶ Operating
 - ▶ Investing
 - ▶ Financing
 - ▶ Cash and cash equivalents
 - ▶ Workings
3. Cash and cash equivalents (b/f, c/f and movement)
4. Statement of profit or loss
 - ▶ PBT
 - “Look up”
 - ▶ Finance costs (interest paid)
 - ▶ Investment income (dividends received)
 - “Look down”
 - ▶ Tax (tax paid)
 - ▶ Profit for the year (dividend paid)
5. Statement of financial position
 - ▶ Working capital (inventory/receivables/payables)
 - ▶ Borrowings
 - ▶ Share capital and share premium
6. Additional information
 - ▶ Cash inflow/outflow (sale of PPE)
 - ▶ Non-cash items (depreciation)
7. Complete the workings and statement of cash flows in the time available



Example 1 – Statement of cash flows

The following information relates to Geofrost, a limited liability company, for the year ended 31 October 20X7.

Extracts from the statement of profit or loss for the year ended 31 October 20X7

	\$'000
Finance costs	(400)
Investment income	180
Profit before tax	15,000
Less tax	4,350
Profit for the year	10,650

Statement of financial position as at 31 October 20X7

	20X7 \$000s	20X6 \$000s
Assets		
Non-current assets	43,282	26,574
Current assets		
Inventory	3,560	9,635
Receivables	6,405	4,542
Cash	2,045	1,063
	<hr/> 12,010	<hr/> 15,240
Total assets	<hr/> 55,292	<hr/> 41,814
Equity and liabilities		
Capital and liabilities		
Ordinary share capital	19,365	17,496
Retained earnings	16,115	6,465
	<hr/> 35,480	<hr/> 23,961
Non-current liabilities		
Loan	8,000	10,300
Current liabilities		
Bank overdraft	1,230	429
Trade payables	7,562	4,364
Taxation	3,020	2,760
	<hr/> 11,812	<hr/> 7,553
Total equity and liabilities	<hr/> 55,292	<hr/> 41,814

Additional information:

1. Depreciation expense for the year was \$4,658,000
2. Assets with a carrying value of \$1,974,000 were disposed of at a profit of \$720,000

Prepare the statement of cash flows for the year ended 31 October 20X7 for Geofrost.

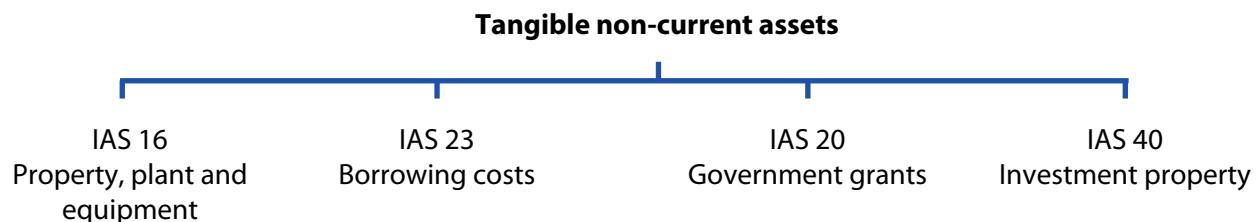




ACCOUNTING STANDARDS

Chapter 5

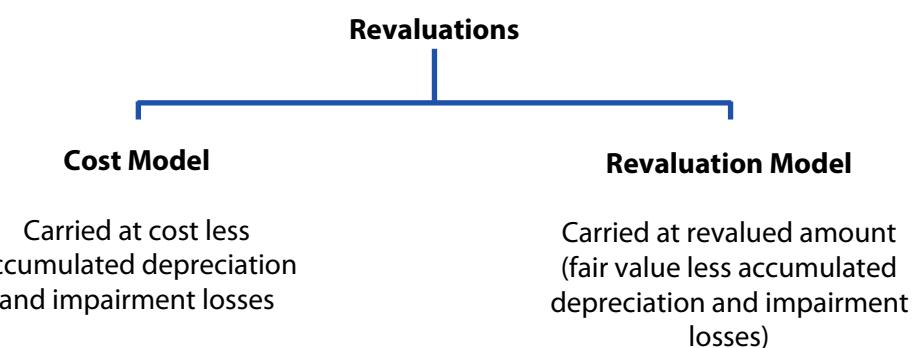
NON-CURRENT ASSETS



1. Property, plant and equipment (IAS 16)

1.1. Measurement at recognition

- At cost
 - ▶ Purchase price
 - ▶ Directly attributable costs in bringing asset to its location and condition
 - ▶ Costs to dismantle/restore (@ present value)



If the asset is carried under the revaluation model, the following must be applied:

- Review periodically and keep revaluations up to date
- Consistent policy for each class of asset (avoids cherry-picking of assets)
- Depreciate the revalued asset less residual value over its remaining useful life



Example 1 – Revaluation increase

Panama bought an item of property, plant and equipment for \$80 million on 1 January 2012. The asset had zero residual value and was to be depreciated over its estimated useful life of 20 years.

On 1 January 2015 the asset was revalued to its fair value of \$95 million.

Calculate the amounts to show in the financial statements of Panama for the year-ended 31 December 2015.

The revaluation decrease will go to the revaluation reserve first, so that the value of the asset is no greater than its depreciated historical cost as if there was no initial revaluation upwards, and any excess will go through profit or loss.

Example 2 – Revaluation decrease

On 1 January 2013, Panama purchased an item of property, plant and equipment for \$12 million. Panama uses the revaluation model to value its non-current assets. The asset has zero residual value and is being depreciated over its estimated useful life of 10 years. At 31 December 2014, the asset was revalued to \$14 million but at 31 December 2015, the value of the asset had fallen to \$8 million. Panama has not taken the effect of the revaluation at 31 December 2015 in its financial statements.

Calculate the amounts to show in the financial statements of Panama for the year-ended 31 December 2015.

1.2. Depreciation

IAS 16 allows two methods of depreciation:

- Straight line
- Reducing balance

Additional factors to consider are as follows:

- Depreciation starts when the asset is ready for its intended use and not from when it starts to be used.
- Any change in estimate is applied prospectively by applying the new estimates to the carrying value of the PPE at the date of change.
- Separate the cost into its component parts and depreciate separately if a complex asset.

Example 3 – Change in estimate

Ecuador bought an item of property, plant and equipment for \$25 million on 1 January 2012 and depreciated over its useful life of 10 years.

On 31 December 2014, the assets remaining life was estimated as 5 years.

Calculate the amounts to show in the financial statements of Ecuador for the year-ended 31 December 2015.



Example 4 – PPE and financial statements

The extracts from the trial balance of Kandy as at 30 September 2014 are:

	\$'000	\$'000
Land (\$5 million) and buildings – at cost	55,000	
Plant and equipment – at cost	58,500	
Accumulated depreciation at 1 October 2013		
: buildings	20,000	
: plant and equipment	34,500	

The following notes are relevant:

Non-current assets:

The price of property has increased significantly in recent years and on 1 October 2013, the directors decided to revalue the land and buildings. The directors accepted the report of an independent surveyor who valued the land at \$8 million and the buildings at \$39 million on that date. The remaining life of the buildings at 1 October 2013 was 15 years. Kandy does not make an annual transfer to retained profits to reflect the realisation of the revaluation gain.

Plant and equipment is depreciated at 12½% per annum using the reducing balance method.

No depreciation has yet been charged on any non-current asset for the year ended 30 September 2014. Depreciation is charged to cost of sales.

Prepare extracts from the statement of profit or loss and other comprehensive income for Kandy for the year ended 30 September 2014 and from the statement of financial position as at the same date with regards property, plant and equipment.

2. Borrowing costs (IAS 23)

Borrowing costs, net of income received from the investment of the money borrowed, on a qualifying asset must be capitalised over the period of construction.

Capitalisation starts when:

- Expenditure on the asset commences
- Borrowing costs are being incurred
- Activities necessary to prepare the asset are in progress

Capitalisation must stop when the asset is ready for its use (whether or not it is being used) or when there is no active construction.

Capitalisation for specific borrowings is capitalised using the **effective rate** of interest.

Example 5 – Specific borrowings

Columbia commenced the construction of an item of property, plant and equipment on 1 March 2015 and funded it with a \$10 million loan. The rate of interest on the borrowings was 5%.

Due to a strike no construction took place between 1 October and 1 November.

Calculate the amount of interest to be capitalised as part of non-current assets if Columbia's reporting date is 31 December 2015.



Illustration – Net borrowing costs

Ecuador has a loan facility of \$300 million upon which interest is charged at 6%. It is also allowed to invest funds and earn a return of 4%.

On 1 March 2018, \$100m was borrowed to construct a new indoor velodrome, of which \$20 million was invested immediately for use later on the project.

On 1 May 2018, work on the construction stopped due to strike action, but work restarted on 1 June 2018 and continued up to the 30 June 2018 reporting date.

The borrowing costs on the \$100 million must be capitalised for three months, from 1 March 2018 to 30 April 2018, and for 1 June 2018 to 30 June 2018. The borrowing costs cannot be capitalised for the month of May due to the strike action where no construction took place. Therefore, borrowing costs of \$1.5 million ($\$100 \text{ million} \times 6\% \times 3/12$) will be capitalised before any investment income is net-off.

The investment income received of \$0.2 million ($\$20 \text{ million} \times 4\% \times 3/12$) will be net-off the \$1.5 million, to give net borrowing costs capitalised of \$1.3 million.

The interest expense for May of \$0.5 million ($\$100 \text{ million} \times 6\% \times 1/12$) and interest income of \$0.07 million will both be recognised through profit or loss.

Example 6 – General borrowings

Venezuela had the following bank loans in issue during 2015.

	\$m
4% bank loan	25
3% bank loan	40

Venezuela commenced the construction of an item of property, plant and equipment on 1 January 2015 for which it used its existing borrowings. \$10 million of expenditure was used on 1 January and \$15 million was used on 1 July.

Calculate the amount of interest to be capitalised as part of the non-current assets during 2015.



3. Government grants (IAS 20)

Recognise the grant when the:

- Entity will comply with the conditions attached to the grant
- Entity will actually receive the grant

Grants should be recognised according to the deferred income approach, using a systematic basis. This spreads the income over the period in which the related expenditure is recognised.

If the grant is used to buy depreciating assets, the grant must be spread over the same life and using the same method.

Example 7 – Grants and depreciable assets

Tweddle bought an item of property, plant and equipment for \$10 million and received a government grant of \$2 million. The PPE has a useful life of 10 years and has no residual value.

Explain how the purchase of the property, plant and equipment and government grant would be dealt with in the financial statements of Tweddle.

Note: If a government grant becomes repayable, it is treated as a change in accounting estimate.

The payment is first shown against any remaining deferred income balance.

If the payment exceeds the deferred income balance then the excess payment is treated as an expense.



4. Investment properties (IAS 40)

Investment property is property (land or a building – or part of a building – or both) held to earn rentals or for capital appreciation or both, rather than for:

- Use in the production or supply of goods and services or for administrative purposes (IAS 16); or
- Sale in the ordinary course of business (IAS 2); or
- Future use as an investment property (IAS 16 until completed)

4.1. Initial measurement

Investment properties should initially be measured at cost plus directly attributable costs.

4.2. Subsequent measurement

Fair value model

- The investment properties are revalued to fair value at each reporting date
- Gains or losses on revaluation are recognised directly through profit or loss
- The properties are not depreciated

Transfers into and out of investment property should only be made when supported by a change of use of the property.

- IP to owner occupied (IAS 16) – Fair value at date of change
- IP to inventory (IAS 2) – Fair value at date of transfer
- Owner occupied (IAS 16) to IP – Revalue under IAS 16 and then treat as IP
- Inventory (IAS 2) to IP – Fair value on change and gain/loss to profit or loss

Cost model

- The investment properties are held using the benchmark method in IAS 16 (cost)
- The properties are depreciated like any other asset

Example 8 – Investment property and change of use

Addlington owns a property that it is using as its head office. At 1 January 2015, its carrying value was \$20 million and its remaining useful life was 20 years. On 1 July 2015 the business was reorganised cheaper premises were found for use as a head office. It was therefore decided to lease the property under an operating lease.

The property was valued by a qualified professional, who assessed the property's value as \$21 million on 1 July and \$21.6 million on 31 December 2015.

Explain the accounting treatment of the property in the financial statements for the year-ended 31 December 2015.

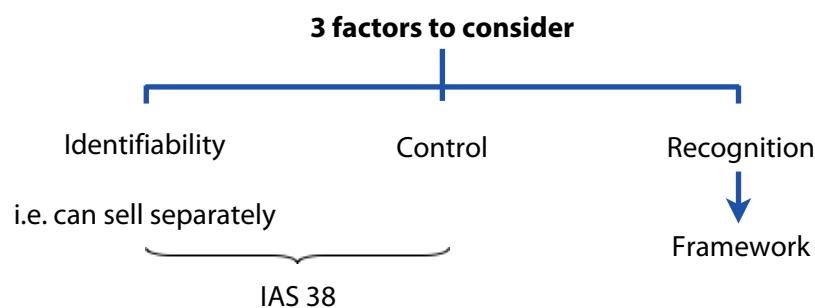


Chapter 6

INTANGIBLE ASSETS (IAS 38)

No physical substance but has value to the business.

- patents
- brand names
- licences



1. Separate acquisition

Capitalise at cost plus any directly attributable costs (e.g. legal fees, testing costs). Amortisation is charged over the useful life of the asset, starting when it is available for use.

2. Research and development

2.1. Research

Research expenditure is charged immediately to profit or loss in the year in which it is incurred.

2.2. Development

Development expenditure must be capitalised when it meets all the criteria.

- Sell/use
- Commercially viable
- Technically feasible
- Resources to complete
- Measure cost reliably (expense)
- Probable future economic benefits (overall)



3. Internally generated

Internally generated brands, mastheads cannot be capitalised as their cost cannot be separated from the overall cost of developing the business.

Example 1 – Intangibles (1)

Which of the following statements are correct?

1. Capitalised development expenditure must be amortised over a period not exceeding five years.
2. Capitalised development costs are shown in the statement of financial position under the heading of non-current assets
3. If certain criteria are met, research expenditure must be recognised as an intangible asset.

A 2 only
B 2 and 3 only
C 1 only
D 1 and 3 only

Example 2 – Intangibles (2)

Booker is involved in developing new products and has spent \$15 million on acquiring a patent to aid in this development. The initial investigative phase of the project cost an additional \$6 million, whereby it was determined that the future feasibility of the product was guaranteed.

Subsequent expenditure incurred on the product was \$8 million, of which \$5 million was spent on the functioning prototype and the remainder on getting the product into a safe and saleable condition.

A further \$1 million was spent on marketing and \$0.5 million on training sales staff on how to demonstrate the use of the product.

At the reporting date the product had not yet been completed.

Explain how Booker should account for the expenditure in its financial statements.

Example 3 – Intangibles (3)

GSK is a large pharmaceutical business involved in the research and development of viable new drugs. It commenced initial investigation into the viability of a new drug on 1 February 20X5 at a cost of \$40,000 per month. On 1 August 20X5 GSK were able to demonstrate the commercial viability of the new drug and intend to sell it on the open market once fully complete.

Costs subsequent to 1 August 20X5 remained at \$40,000 per month. At 31 December 20X5, GSK's reporting date, the drug was not yet complete but it is believed that by mid-20X6 the drug will be available for sale.

The finance director is confident of the success of the drug's sales that he wishes to revalue the intangible at the reporting date, using a discounted future cash flow model to establish the fair value.

Explain the treatment of the above costs in GSK's financial statements for the year-ended 31 December 20X5.



Chapter 7

IMPAIRMENTS (IAS 36)

1. Identify possible impairment indicators (external vs. internal)
2. Perform impairment review (if identified possible impairments)
3. Record the impairment

1. Indicators of Impairment

External sources

- A significant decline in the asset's market value more than expected by normal use or passage of time
- A significant adverse change in the technological, economic or legal environment

Internal sources

- Obsolescence or physical damage
- Significant changes, in the period or expected, in the way the asset is being used e.g. asset becoming idle, plans for early disposal or discontinuing/ restructuring the operation where the asset is used
- Evidence that asset's economic performance will be worse than expected
- Operating losses or net cash outflows for the asset
- Loss of key employee

2. Impairment review

If the carrying value of the asset is greater than its recoverable amount, it is impaired and should be written down to its recoverable amount.

- **Recoverable amount** - the greater of fair value less cost to sell and value in use.
- **Fair value less costs to sell** - the amount receivable from the sale of the asset less the costs of disposal.
- **Value in use** - the present value of the future cash flows from the asset.

Example 1 – Impairment

A machine was acquired on 1 January 20X5 at a cost of \$50,000 and has a useful economic life of ten years.

At 31 December 20X9 an impairment review was performed. The fair value of the machine is \$26,000 and the selling costs are \$2,000.

The expected future cash flows are \$5,000 per annum for the next five years. The current cost of capital is 10%. An annuity factor for this rate over this period is 3.791

Prepare extract from the financial statement for the year-ended 31 December 20X9.



3. Record the impairment

Individual asset

The reduction in carrying value is taken through profit or loss unless related to a revalued asset, in which case it is taken to any revaluation surplus first.

Example 2– Individual asset impairment

A building was bought on 1 January 20X1 at a cost of \$1,000,000 and has a useful life of 20 years.

The company uses the revaluation model for its land and buildings, and on the 31 December 20X5 the fair value of the building was \$1,125,000. The company opts to transfer any excess depreciation on the revalued amount to retained earnings.

On the 31 December 20X7 a fall in the market value of property led to an impairment review on the building, which revealed the value of the building to be \$600,000.

Explain how the impairment of the building should be dealt with in the financial statements for the year ended 31 December 20X7.

Cash generating unit (CGU)

The impairment loss is allocated as follows:

1. Specific assets
2. Goodwill
3. Remaining assets (pro-rata)

Example 3 – CGU impairment

Peter owned 100% of the equity share capital of Sharon, a wholly-owned subsidiary.

The assets at the reporting date of Sharon were as follows:

	\$'000
Goodwill	2,400
Buildings	6,000
Plant and equipment	5,200
Other intangibles	2,000
Receivables and cash	<u>1,400</u>
	<u>17,000</u>

On the reporting date a fire within one of Sharon's buildings led to an impairment review being carried out.

The recoverable amount of the business was determined to be \$9.8 million. The fire destroyed some plant and equipment with a carrying value of \$1.2 million and there was no option but to scrap it.

The other intangibles consist of a licence to operate Sharon's plant and equipment. Following the scrapping of some of the plant and equipment a competitor offered to purchase the patent for \$1.5 million.

The receivable and cash are both stated at their realisable value and do not require impairment.

Show how the impairment loss in Sharon is allocated amongst the assets.

Note: Within a group of companies where there are several subsidiaries, the individual CGUs (subsidiaries) are tested for impairment first, before the overall value of the business is tested.



Chapter 8

NON-CURRENT ASSETS HELD FOR SALE AND DISCONTINUED OPERATIONS (IFRS 5)

1. Objective

- To require entities to disclose information about operations which have been discontinued during the accounting period
- Improves the reader's ability to interpret the results and to make meaningful projections

2. Non-current assets held for sale

- A non-current asset held for sale is one where the carrying amount will be recovered principally through sale rather than through continuing use
- A disposal group is a group of (net) assets to be disposed of in a single sale transaction

To be classified as 'held for sale' it must be:

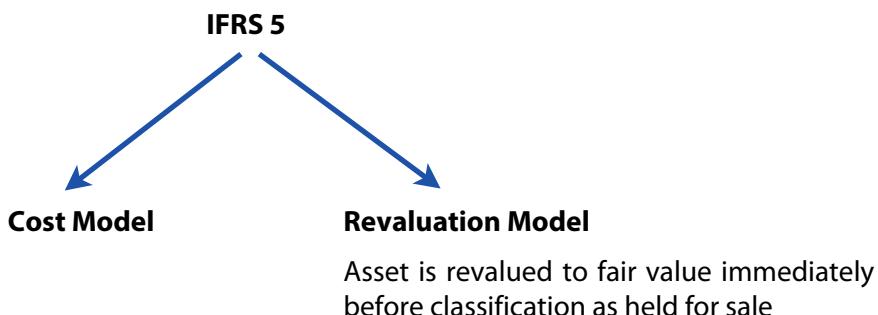
- Available for immediate sale in its present condition and,
- Its sale must be highly probable

For a sale to be highly probable

- Management must be committed to a plan to sell the asset
- An active programme to locate a buyer and complete the plan must have been started
- The asset must be being actively marketed at a price that is reasonable in relation to its current fair value
- The sale should be expected to take place within twelve months from the date of classification as 'held for sale'
- It should be unlikely that significant changes to the plan will be made or that the plan will be withdrawn

Non-current asset held for sale is valued at the lower of the carrying value and fair value less costs to sell. Any reduction in value is recorded as an impairment through profit or loss.





- Once classified as a non-current asset held for sale it is no longer depreciated.
- The subsequent sale of the asset will give rise to a profit/loss on disposal.

Example 1 – NCA-HFS

York bought an asset at a cost of \$120,000 on 1 January 20X1 and depreciated it straight line over 10 years. The asset's residual value is nil and depreciation is charged pro-rate on a monthly basis.

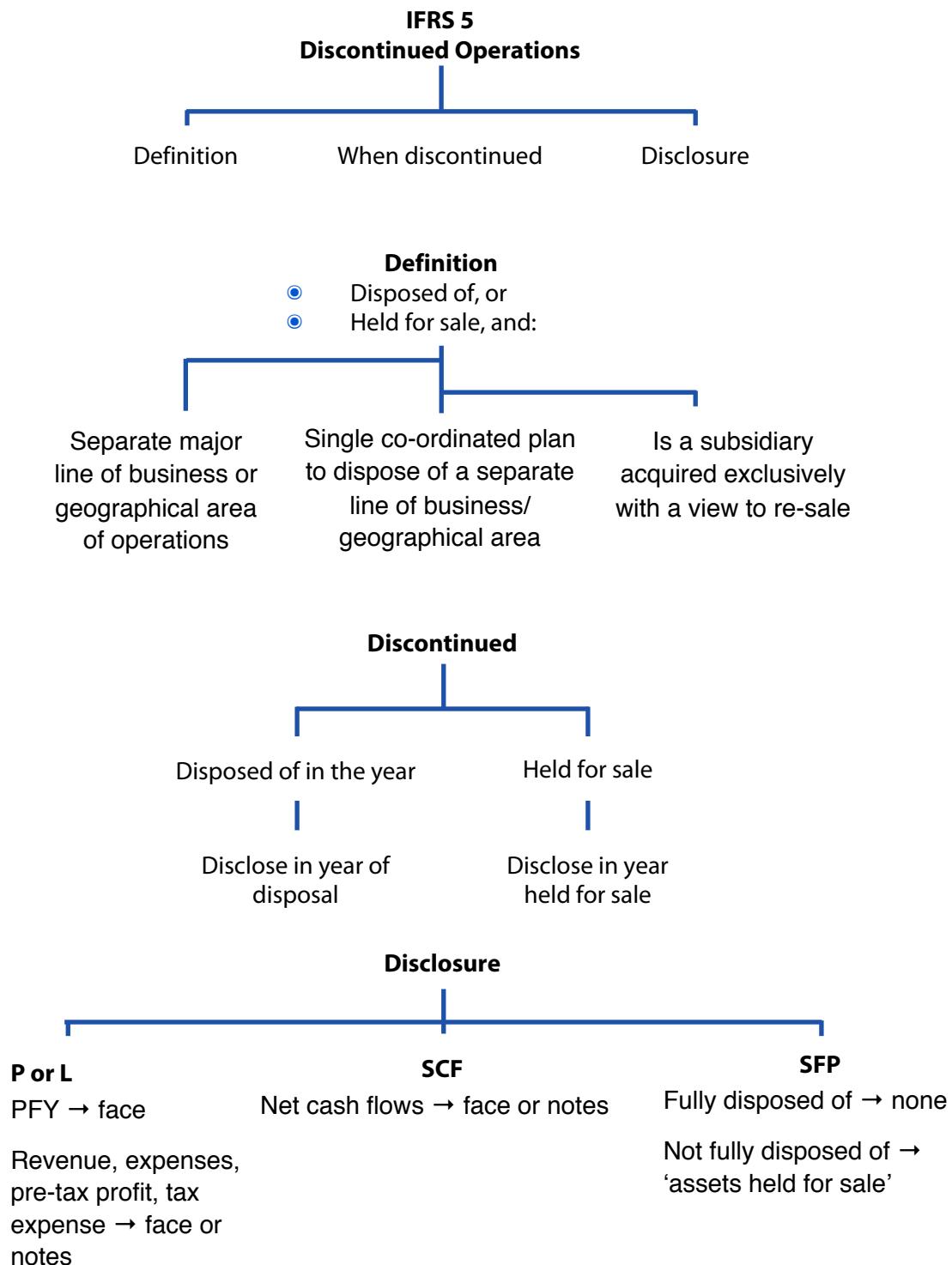
On 30 November 20X4, York classified the asset as a non-current asset held for sale in accordance with the rules of IFRS 5 Discontinued operations and non-current assets held for sale. At that date the fair value of the asset was \$70,000 and the costs to sell were \$2,000.

The asset had not been sold by the 31 December 20X4 reporting date.

Prepare extracts from the financial statements for the year-ended 31 December 20X4.



3. Discontinued operations



Example 2 – Discontinued operations

Angola's car manufacturing operation has been making substantial losses. Following a meeting of the board of directors, it was decided to close down the car manufacturing operation on 31 March 20X6. The company's reporting date is 31 December and the car manufacturing operation is treated as a separate operating segment.

Explain how the decision to close the car manufacturing operation should be treated in Angola's financial statements for the years ending 31 December 20X5 and 20X6.

Example 3 – Discontinued operations

Ruta Co Statement of Profit or Loss and Other Comprehensive Income for the year ended 31 December 2017

	\$000	\$000
	2017	2016
Revenue	700	550
Cost of sales	(300)	(260)
Gross profit	400	290
Distribution costs	(100)	(70)
Administrative expenses	(70)	(60)
Profit from operations	230	160

During the year the entity ran down a material business operation with all activities ceasing on 30 March 2017

The results of the operation for 2017 and 2016 were as follows:

	\$000	\$000
	2017	2016
Revenue	60	70
Cost of sales	(40)	(45)
Distribution costs	(13)	(14)
Administrative expenses	(10)	(12)
Loss from operations	(3)	(1)

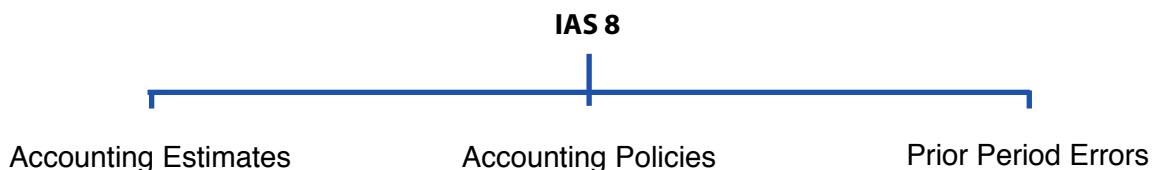
The entity made gains of \$7,000 on the disposal of non-current assets of the discontinued operation. These have been netted off against administrative expenses.

Prepare the Statement of Profit or Loss and Other Comprehensive Income for the year ended 31 December, 2017 for Ruta Co, complying with the provisions of IFRS 5, disclosing the information on the face of the Statement of Profit or Loss and Other Comprehensive Income. Ignore taxation.

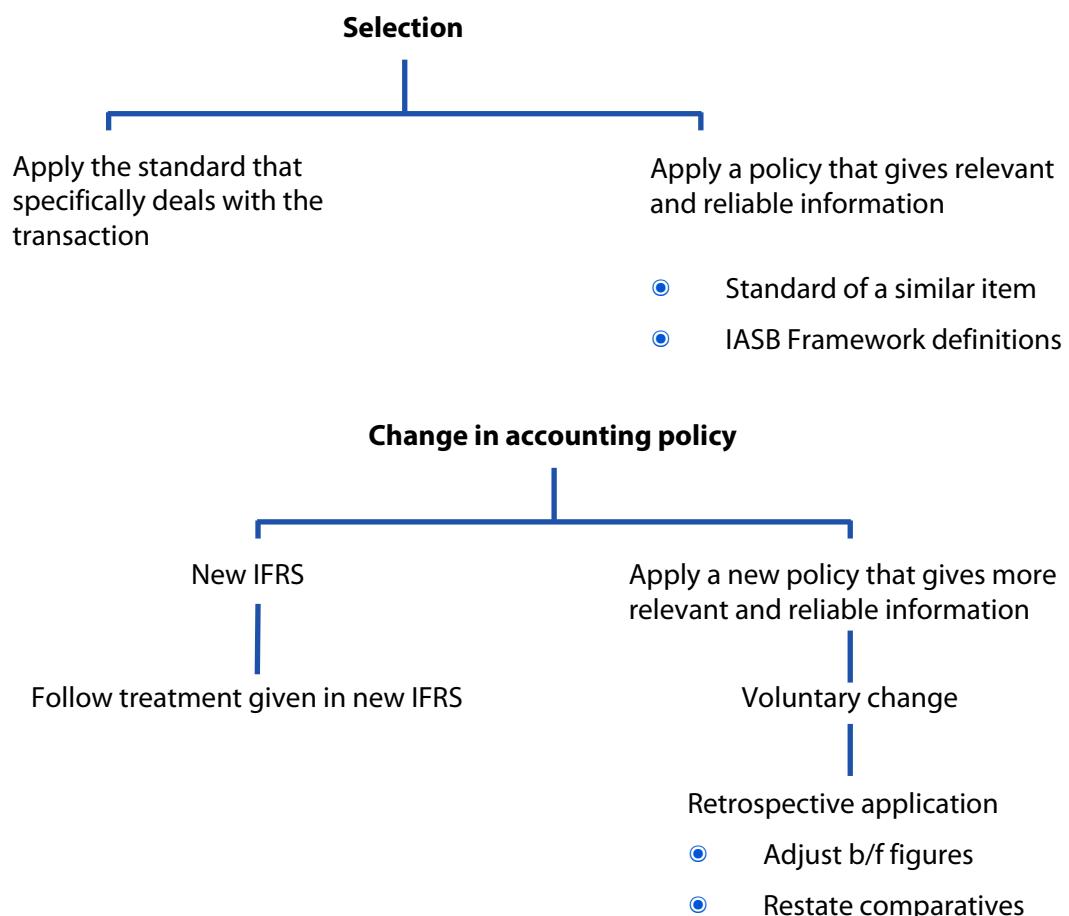


Chapter 9

ACCOUNTING POLICIES, CHANGES IN ACCOUNTING ESTIMATE AND ERRORS (IAS 8)



1. Accounting policies



Example 1 – Error

Adomas Co Statement of Profit or Loss and Other Comprehensive Income extract and summarised Statement of Financial Position for the year ended 31 December, 2008

	\$'000
Revenue	2,500
Cost of sales and expenses	(1,200)
Profit for the year	1,300

Statement of Financial Position at 31 December, 2008

Non-current assets	2,000
Current assets	800
	<hr/>
Share capital	600
Reserves	2,000
	<hr/>
Current liabilities	200
	<hr/>
	2,800

During 2009 it was discovered that certain non-current assets had been included in the records at 31 December 2008 at \$500,000 in excess of their recoverable amount and that this situation was unlikely to change.

Prior to making any adjustment for the above the results and summarised Statement of Financial Position of Adomas Co for 2009 was as follows:

Statement of Profit or Loss (extract) for the year ended 31 December 2009

	\$'000
Revenue	2,600
Costs and expenses	(1,400)
Profit for the year	1,200

Statement of Financial Position at 31 December 2009

	\$'000
Non-current assets	2,800
Current assets	1,700
	<hr/>
Share capital	600
Retained earnings	3,500
	<hr/>
Current liabilities	400
	<hr/>
	4,500

During 2009 some other items of property had been revalued by \$300,000 (included in the above retained earnings figure).

Prepare extracts from Adomas Co's financial statements for the year ended 31 December, 2009.



2. Accounting estimates

Changes in accounting estimate are recognised prospectively:

- Period of change
- Period of change and future periods

Example 2 – Accounting Estimates

Would the following be a change in accounting policy or revision of an estimate?

1. If a company decides to change its method of depreciation from straight line method to reducing balance method.
2. If a company decides to change from capitalising finance costs to immediate write off.

3. Prior period error

Accounting errors (omissions and misstatements) include:

- Errors in applying accounting policies
- Oversight
- Fraud and the effects of fraud

Material errors are corrected retrospectively, the same as for a change in accounting policy.

Example 3 – Prior year error

Fraudulent financial reporting has been found within the accounts of Dodgy Co, which amounts to \$3.4m of trade receivables that need to be written off. Of the total \$3.4m, \$1.0m relates to the current reporting period, and the remaining \$2.4m relates to previous period.

Explain the accounting treatment of the fraudulent financial reporting in the financial statements of Dodgy Co.





Chapter 10

INVENTORY (IAS 2) AND AGRICULTURE (IAS 41)

1. Inventory (IAS 2)

Measure @ lower of		
Cost	NRV	
Costs incurred in bringing inventory to its present condition and location	Selling price	X
● Materials	Less:	
● Labour	Costs to complete	(X)
● Manufacturing overheads (based on normal output)	Costs of selling	(X)
	NRV	X

Example 1 – Inventory (cost)

According to IAS 2 Inventories, which TWO of the following costs should be included in valuing the inventories of a manufacturing company?

1. Carriage inwards
2. Carriage outwards
3. Depreciation of factory plant
4. General administrative overheads

A 1 and 4
B 1 and 3
C 3 and 4
D 2 and 3



Example 2 – Inventory (valuation)

Neil paid \$3 per unit for the raw materials of its products. To complete each unit incurred \$2 per unit in direct labour.

Production overheads for the year based on normal output of 12,000 units was \$72,000.

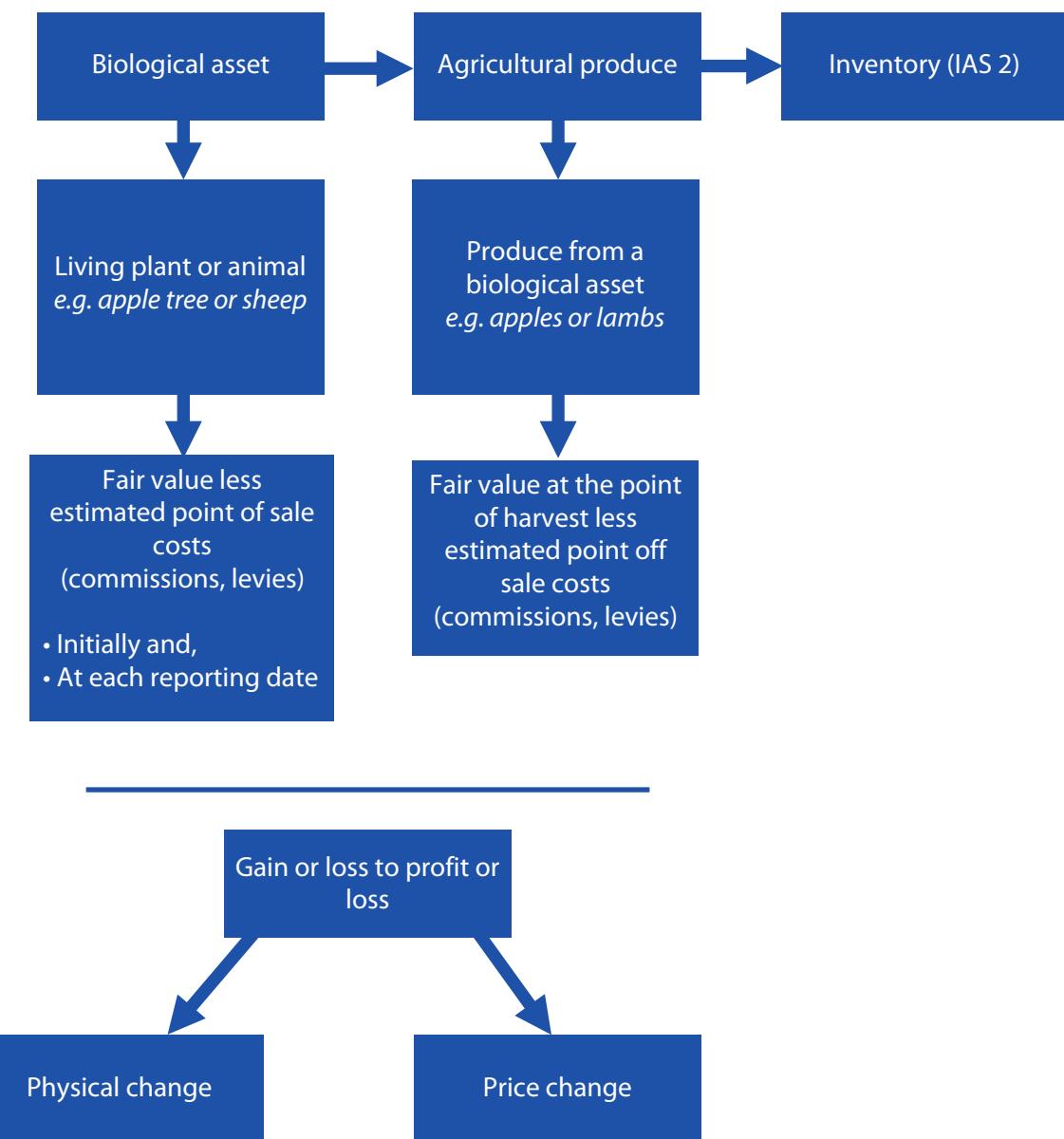
Due to industrial action only 10,000 units were produced and 1,000 units were in inventory at the end of the year.

As a result of the industrial action some units were badly stored and became damaged. It's is estimated that 200 of the units will now only be sold for \$12 each after minor repairs of \$2 each

What figure for closing inventory would be shown in the Statement of Financial Position?



2. Agriculture (IAS 41)



Note:

- Agricultural land is accounted for under IAS 16 Property, plant and equipment
- Milk quotas are accounted for under IAS 38 Intangible assets
- Grant income for agricultural activity is credited to profit or loss as soon as they are unconditionally receivable.





Chapter 11

FINANCIAL INSTRUMENTS (IFRS 9)

Company A		Company B
Financial asset		Financial liability, or equity
Purchase shares in co. B	→	Issues shares
Purchase co. B debt	→	Issues debt
Sells goods to B	→	Buys good from A

1. Financial assets

1.1. Initial measurement

- Initially recognise at fair value including transaction costs, unless classified as fair value through profit or loss

1.2. Subsequent measurement

1.2.1 Equity instruments

Fair value through profit or loss (default)

- Transaction costs are recognised immediately through profit or loss
- Re-measure to fair value at the reporting date, with gains or losses through profit or loss

Fair value through other comprehensive income

If there is a strategic intent to hold the asset the option to hold at fair value through other comprehensive income is available. Re-measure to fair value at reporting date, with gains or losses through other comprehensive income.

1.2.2 Debt instruments

Amortised cost

A financial asset is measured at amortised cost if it fulfils both of the following tests:

- Business model test – intent to hold the asset until its maturity date; and,
- Contractual cash flow test – contractual cash receipts on holding the asset.

Fair value through other comprehensive income

The investment in debt can be classified as FVTOCI if the objective of the business model is to instead collect the cash receipts **and** sell the financial asset.



1.3. Derecognition

Financial assets are derecognised when sold, with gains or losses on disposal through profit or loss. Gains or losses previously recognised through other comprehensive income are transferred to retained earnings through the statement of changes in equity.

Example 1 – Financial assets

Norman has the following financial assets during the financial year.

1. Norman bought 100,000 shares in a listed entity on 1 November 2015. Each share cost \$5 to purchase and a fee of \$0.25 per share was paid as commission to a broker. The fair value of each share at 31 December 2015 was \$3.50.
2. Norman bought 200,000 shares in a listed entity on 1 March 2015 for \$500,000, incurring transaction costs of £40,000. Norman acquired the shares as part of a long term strategy to realise the gains in the future. The fair value of the shares was £620,000 at 31 December. The shares were subsequently sold for \$650,000 on 31 January 2016.
3. Norman bought 10,000 debentures at a 2% discount on the par value of \$100. The debentures are redeemable in four years' time at a premium of 5%. The coupon rate attached to the debentures is 4%. The effective rate of interest on the debenture is 5.73%.

Explain how each of the above financial assets will be accounted for in the financial statements.



2. Financial liabilities

2.1. Initial measurement

- Initially recognise at fair value less transaction costs ('net proceeds')

2.2. Subsequent measurement

- Amortised cost
- Fair value through profit or loss

2.3. Derecognition

- Financial liabilities are derecognised when they have been paid in full or transferred to another party.

Example 2 – Financial liabilities

Norma issues 20,000 redeemable debentures at their \$100 par value, incurring issue costs of \$100,000. The debentures are redeemable at a 5% premium in 4 years' time and carry a coupon rate of 2%. The effective rate on the debenture is 4.58%.

Calculate the amounts to be shown in the statement of financial position and statement of profit or loss for each of the four years of the debenture.

3. Convertible debentures

If a convertible instrument is issued, the economic substance is a combination of equity and liability and is accounted for using split equity accounting.

The liability element is calculated by discounting back the maximum possible amount of cash that will be repaid assuming that the conversion doesn't take place. The discount rate to be used is that of the interest rate on similar debt without a conversion option.

The equity element is the difference between the proceeds on issue and the initial liability element.

The liability element is subsequently measured at amortised cost, using the interest rate on similar debt without the conversion option as the effective rate. The equity element is not subsequently changed.

Example 3 – Convertible debentures

Alice issued one million 4% convertible debentures at the start of the accounting year at par value of \$100 million.

The rate of interest on similar debt without the conversion option is 6%.

Explain how Alice should account for the convertible debenture in its financial statements for each of the three years.



4. Disclosure (IFRS 7)

Financial instruments, particularly derivatives, often require little initial investment, though may result in substantial losses or gains and as such stakeholders need to be informed of their existence. The objective of IFRS7 is to allow users of the accounts to evaluate:

- The significance of the financial instruments for the entity's financial position and performance
- The nature and extent of risks arising from financial instruments
- The management of the risks arising from financial instruments

Nature and extent of financial risks

Financial risk arising from the use of financial instruments can be defined as:

- Credit risk
- Liquidity risk
- Market risk

Disclosures with regards to these risks need to be both **qualitative** and **quantitative**.



Chapter 12

LEASES (IFRS 16)

IFRS 16 Leases is to be adopted for accounting periods starting on or after 1 January 2019. It can be adopted earlier but only if the entity has already adopted IFRS 15 Revenue from contracts with customers.

The new standard on leases is replacing the old standard (IAS 17) where the existence of operating leases meant that significant amounts of finance were held off the balance sheet. In adopting the new standard all leases will now be brought on to the statement of financial position, except in the following circumstances:

- leases with a lease term of 12 months or less and containing no purchase options – this election is made by class of underlying asset; and
- leases where the underlying asset has a low value when new (such as personal computers or small items of office furniture) – this election can be made on a lease-by-lease basis.

The accounting for low value or short-term leases is done through expensing the rental through profit or loss on a straight-line basis.

Example 1 – Low-value assets

Banana leases out a machine to Mango under a four year lease and Mango elects to apply the low-value exemption. The terms of the lease are that the annual lease rentals are \$2,000 payable in arrears. As an incentive, Banana grants Mango a rent-free period in the first year.

Explain how Mango would account for the lease in the financial statements.



1. Lessee accounting

1.1. Initial recognition

At the start of the lease the lessee initially recognises a right-of-use asset and a lease liability. [IFRS 16:22]

Right of use asset	Lease liability
Measured at the amount of the lease liability plus any initial direct costs incurred by the lessee.	Measured at the present value of the lease payments payable over the lease term, discounted at the rate implicit in the lease
<ul style="list-style-type: none"> <input type="radio"/> Lease liability <input type="radio"/> Initial direct costs <input type="radio"/> Estimated costs for dismantling <input type="radio"/> Payments less incentives before commencement date 	<ul style="list-style-type: none"> <input type="radio"/> Fixed payments less incentives <input type="radio"/> Variable payments (e.g. CPI/rate) <input type="radio"/> Expected residual value guarantee <input type="radio"/> Penalty for terminating (if reasonably certain) <input type="radio"/> Exercise price of purchase option (if reasonably certain)
	<p>Note: if the rate implicit in the lease cannot be determined the lessee shall use their incremental borrowing rate</p>

1.2. Subsequent measurement

Right of use asset	Lease liability
Cost less accumulated depreciation	Financial liability at amortised cost
<p>Note: Depreciation is based on the earlier of the useful life and lease term, unless ownership transfers, in which case use the useful life.</p>	

Example 2 – Lessee accounting

On 1 January 2015, Plum entered into a five year lease of machinery. The machinery has a useful life of six years. The annual lease payments are \$5,000 per annum, with the first payment made on 1 January 2015. To obtain the lease Plum incurs initial direct costs of \$1,000 in relation to the arrangement of the lease but the lessor agrees to reimburse Plum \$500 towards the costs of the lease.

The rate implicit in the lease is 5%. The present value of the minimum lease payments is \$22,730.

Demonstrate how the lease will be accounted in the financial statements over the five year period.



2. Sale and leaseback

A sale and leaseback transaction occurs when one entity (seller) transfers an asset to another entity (buyer) who then leases the asset back to the original seller (lessee).

The companies are required to account for the transfer contract and the lease applying IFRS 16, however consideration is first given to whether the initial sale of the transferred asset is a performance obligation under IFRS 15.

If the transfer of the asset is **not a sale** then the following rules apply:

<i>Seller-Lessee</i>	<i>Buyer-Lessor</i>
<input type="radio"/> Continue to recognise the asset	<input type="radio"/> Do not recognise the asset
<input type="radio"/> Recognise a financial liability (= proceeds)	<input type="radio"/> Recognise a financial asset (= proceeds)

If the transfer of the asset is a sale then the following rules apply:

<i>Seller-Lessee</i>	<i>Buyer-Lessor</i>
<input type="radio"/> Derecognise the asset	<input type="radio"/> Recognise purchase of the asset
<input type="radio"/> Recognise the sale at fair value	
<input type="radio"/> Recognise lease liability (PV of lease rentals)	<input type="radio"/> Apply lessor accounting
<input type="radio"/> Recognise a right-of-use asset, as a proportion of the previous carrying value of underlying asset	
<input type="radio"/> Gain/loss on rights transferred to the buyer	

Example 3 – Sale and leaseback (1)

Apple required funds to finance a new ambitious rebranding exercise. It's only possible way of raising finance is through the sale and leaseback of its head office building for a period of 10 years. The lease payments of \$1 million are to be made at the end of the lease period

The current fair value of the building is \$10 million and the carrying value is \$8.4 million. The interest rate implicit in the lease is 5%.

Advise Apple on how to account for the sale and leaseback in its financial statements if the office building were to be sold at the fair value of \$10 million and:

- (a) **Performance obligations are not satisfied; or,**
- (b) **Performance obligations are satisfied.**

Note: If the proceeds are less than the fair value of the asset or the lease payments are less than market rental the following adjustments to sales proceeds apply:

- Any below-market terms should be accounted for as a prepayment of the lease payments; and,
- Any above-market terms should be accounted for as additional financing provided to the lessee.



Example 4 – Sale and leaseback (2)

Apple required funds to finance a new ambitious rebranding exercise. Its only possible way of raising finance is through the sale and leaseback of its head office building for a period of 10 years. The lease payments of \$1 million are to be made at the end of the lease period.

The current fair value of the building is \$10 million and the carrying value is \$8.4 million. The interest rate implicit in the lease is 5%.

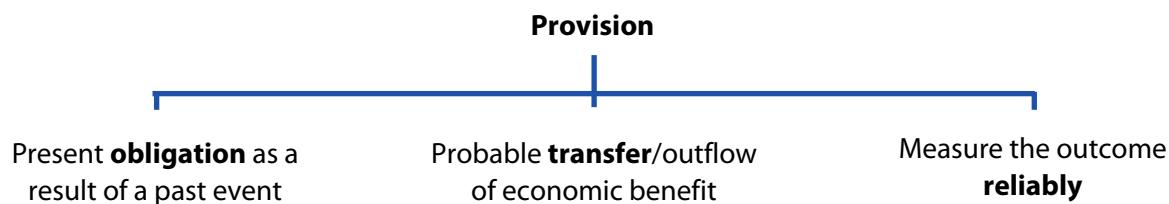
Advise Apple on how to account for the sale and leaseback in its financial statements if the performance obligations are satisfied and the building is sold for the following:

- (a) \$9 million; or,
- (a) \$11 million.



Chapter 13

PROVISIONS, CONTINGENT ASSETS AND LIABILITIES (IAS 37)



1. Measurement

- Best estimate of expenditure
- Expected values (various different outcomes)
- Discount to present value if materially different

Illustration – Best estimate (single obligation)

Following the explosion of an oil rig in the North Sea that resulted in large amounts of environmental damage the company was taken to court by the local authority who were looking to recover the costs of the clean-up operation. The company has been informed by their lawyers that it was probable that they would be liable for the costs of the clean-up operation. The lawyers estimated that following financial settlements and their likelihood:

<i>Settlement amount (\$m)</i>	<i>Likelihood of settlement</i>
25	20%
40	45%
65	35%

For a single obligation that is being measured, i.e. the payment to clean-up the environmental damage, the best estimate of the liability is the individual most likely outcome.

The most likely outcome is the settlement for \$40 million and so this is the amount that would be provided for within the financial statements.



Illustration – Best estimate (large population)

A company sells second hand cars with a six-month warranty that promises to repair the cars if any faults occur following the sale. The company has estimated that 80% of the cars sold in the last six-months will require no repairs, however 15% will require minor repairs and the remaining 5% will require major repairs.

The company has estimated that if all the cars were to have minor repairs then this would cost \$100,000 and if all the cars were to have major repairs then this would cost \$500,000.

For a large population of items, the best estimate of the provision is based on an expected value of the possible outcomes. The expected value of the repair costs is \$40,000 $[(80\% \times \$\text{nil}) + (15\% \times \$100,000) + (5\% \times \$500,000)]$ and so this is the amount that would be provided for within the financial statements.

Example 1 – Discounting and provisions

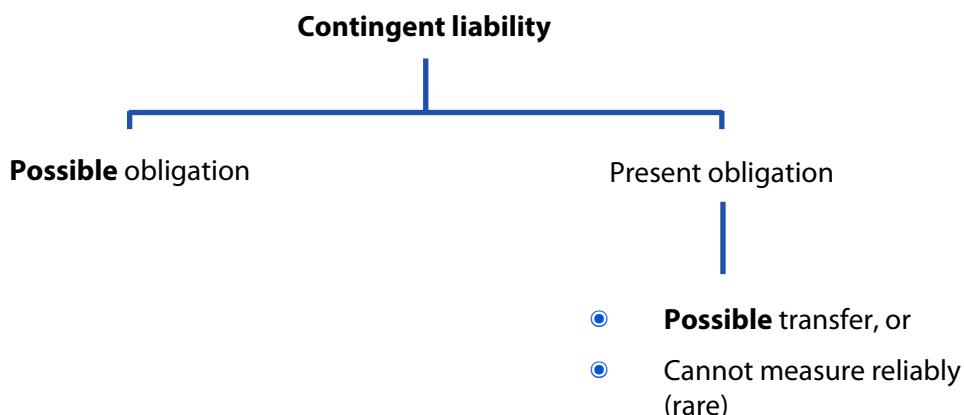
HR Co has a year end of 31 December 2018, and it was notified that on the 1 July 2018 a former employee brought about a legal claim for unfair dismissal. HR Co's legal team have said that it is probable that that HR Co would lose the case, resulting in a payment of \$495,000 on 30 June 2019.

HR Co has a cost of capital of 10% per annum. A one year discount factor at 10% is 0.9091.

Calculate the amounts to be recognised in the financial statements of HR Co for the year ended 31 December 2018

2. Subsequent treatment

- Review the provision annually
- Only use the provision for expense originally created



Example 2 – Provisions and contingencies (1)

The following items have to be considered when finalising the financial statements of G-Star Co, a limited liability company:

The company gives warranties on its products. The company's statistics show that about 5% of sales give rise to a warranty claim.

The company has guaranteed the overdraft of another company. The likelihood of a liability arising under the guarantee is assessed as possible.

What is the correct action to be taken in the financial statement for these items?

	Item 1	Item 2
A	Create a provision	Disclose by note only
B	Disclose by note only	No action
C	Create a provision	Create a provision
D	Disclose by note only	Disclose by note only

Example 3 – Provisions and contingencies (2)

Justina supplies fish to a local restaurant. In August 2009 she supplied the restaurant with some shell-fish, and now she has heard that some of the restaurant's customers have suffered attacks of food-poisoning. The restaurant has claimed that this is because of Justina's shell-fish, and has commenced a legal action against her.

Algirdas, a local solicitor who specialises in food-poisoning cases, has advised Justina that she has a 42% chance of losing the case, and that, if she does lose, she will probably have to pay \$300,000 to settle the liability.

What is the nature of Justina's liability, if any, and how should it be treated in her financial statements for the year ended 31 August, 2009?



3. Specifics

Future operating losses

No provision can be made for anticipated losses as there is no obligation.

Onerous contracts

An onerous contract is whereby the cost of fulfilling the contract exceed the benefits received from the contract (e.g. non-cancellable operating lease).

A provision is recognised at the lower of:

- Present value of continuing under the contract, and
- Present value of exiting the contract

Example 4 – Onerous contract

Daiva has a contract to buy 900 metres of cloth each month for \$7 per metre. From each 3 metres of cloth she can make a dress which she can sell for \$30. She also incurs labour costs of \$4 per dress. Alternatively she can sell the cloth immediately for \$6.25 per metre.

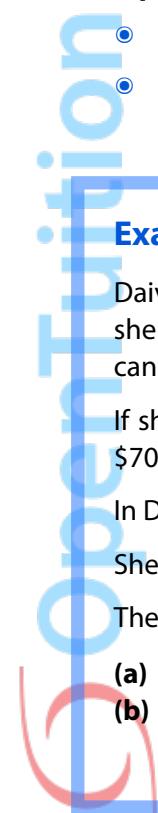
If she decides to cancel the cloth purchase contract without notice she must pay a cancellation penalty of \$700, for each of the next two months.

In December 2009 the market price of dresses fell to \$22.

She is considering ceasing production since she believes that the market will not improve.

There is 2 months notice stated in the contract in case of breach of a contract.

- (a) **Is there a present obligation?**
- (b) **What will appear in respect of the contract in Daiva's financial statements for the year ending 31 December, 2009.**



Restructuring

- Sale or closure of a line of business
- Ceasing activities in a geographical location
- Relocating activities
- Re-organisation (management or focus of operations)

A provision is recognised if there is a detailed formal plan and the plan has been announced.

The provision only includes costs which are necessarily to be incurred and not associated with continuing activities.

Example 5 – Restructuring

On 18 August 2017 the directors of Paulius decided to close the Kaunas Factory.

- (a) Assuming that no steps were taken to implement the decision and the decision was not communicated to any of those affected by the Statement of Financial Position date of 31 August, 2017 what is the appropriate accounting treatment?
- (b) What would be the appropriate accounting treatment for the closure if a detailed plan had been agreed by the board on 26 August 2017, and letters sent to notify suppliers? The workforce in Kaunas has been sent redundancy notices.

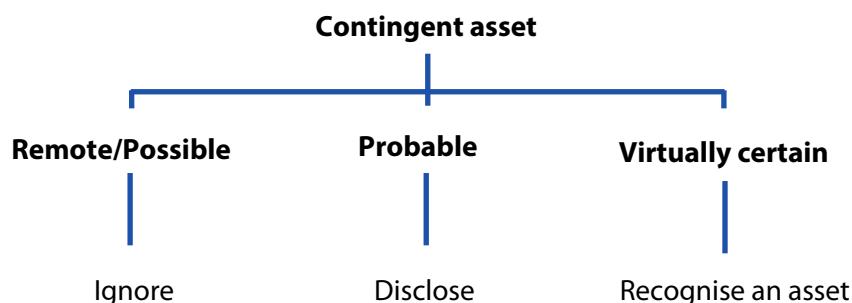


Illustration – Contingent asset

A business has a reporting date of 31 December and inventory worth \$100,000 was stolen just prior to the reporting date. The business has made a claim on its insurance and has heard from the insurers who have said that it is probable that the full amount will be reimbursed, but no further confirmation of when any payment will be made has been received.

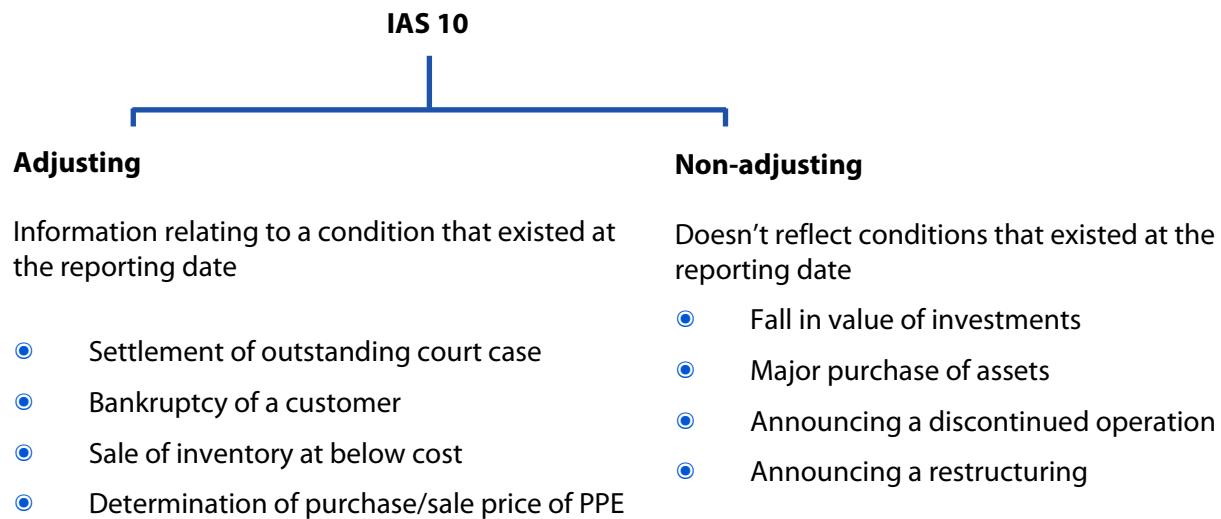
The business will disclose a contingent asset within the notes to the accounts as it is probable that the \$100,000 will be received, however an asset cannot be recognised as it is not yet virtually certain as the final confirmation has not been received of when the payment will be received.





Chapter 14

EVENTS AFTER THE REPORTING DATE (IAS 10)



Example 1 – Events after the reporting period

Which of the following material events after the reporting date and before the financial statements are approved are adjusting events?

1. A valuation of property providing evidence of impairment in value at the reporting date.
2. Sale of inventory held at the reporting date for less than cost.
3. Discovery of fraud or error affecting the financial statements.
4. The insolvency of a customer with a debt owing at the reporting date which is still outstanding.

A 1, 2 and 4 only
B 1, 2, 3 and 4
C 1 and 4 only
D 2 and 3 only



Example 2– Events after the reporting period

The following events took place between the 31 December 2017 reporting date and the date the financial statements were authorised for issue.

- The company makes an issue of 100,000 shares which raises \$200,000 shortly after the Statement of Financial Position date.
- A legal action had been brought against the company for breach of contract prior to the year end. The outcome was decided shortly after the Statement of Financial Position date, and as a result the company will have to pay costs and damages totalling \$80,000. No provision has currently been made for this event.
- Inventory included in the accounts at the year end at cost \$25,000 was subsequently sold for \$15,000.
- A building in use at the Statement of Financial Position date and valued at \$500,000 was completely destroyed by fire. Unfortunately, only half of the value was covered by insurance

Which of the above events are adjusting events in the financial statements.



Chapter 15

INCOME TAXES (IAS 12)

1. Current tax

Current tax is the amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period.

2. Recognition

Current tax should be recognised based on the year-end estimate of the tax payable. The income tax expense though profit or loss is adjusted for any under/over provision from the prior year.

Example 1 – Current tax

The following trial balance (extract) relates to Clarion as at 31 March 2015:

	\$'000	\$'000
Current tax		400

The following notes are also relevant:

A provision for current tax for the year ended 31 March 2015 of \$3.5 million is required.

The balance on current tax in the trial balance represents the under/over provision of the tax liability for the year ended 31 March 2014.

Prepare extracts from the statement of profit or loss for Clarion for the year ended 31 March 2015 and from the statement of financial position as at the same date with regards tax.



3. Deferred tax

Deferred tax arises because;

Accounting profit (PFY) \neq Taxable profit (PCTCT)

The reasons for this can be split into two categories:

- ◎ **Permanent differences**

Items that would have been used in calculating accounting profit but would NOT be used in calculating taxable profit e.g. some entertaining expenses

- ◎ **Temporary differences**

Items that would have been used in calculating accounting profit and taxable profit but in different accounting periods e.g. depreciation/tax allowances.

IAS 12 considers only temporary differences and it arises on temporary differences between the carrying value of an asset or liability and its tax base.

Example 2 – Tracy (ignoring deferred tax)

Tracy purchased an item of property, plant and equipment on 1 January 20X5 for \$5 million. It was estimated that it had a useful economic life of 5 years but according to the tax authority had a 50% tax allowance in its first year and 20% reducing balance thereafter.

Tracy made an accounting profit of \$2m for the year, which is expected to continue unchanged for the next two years.

Income tax rate 20%

Ignoring deferred tax calculate the profits after tax for Tracy for each of the three years ending 31 December 20X5 to 20X7.

4. Calculating deferred tax

- Calculate the temporary difference, as being the difference between the carrying value of the asset or liability and its tax base.

	\$'000s
Carrying value	X
Tax base	X
Temporary difference	X

- Calculate the deferred tax position by multiplying the temporary difference by the income tax rate at which the asset or liability will be settled at.

$X\% \times \text{temporary difference} = \text{closing deferred tax provision}$

- The closing deferred tax position is either a deferred tax asset or a liability.

A deferred tax liability arises if:

Carrying value > Tax base – taxable temporary difference

A deferred tax asset arises if:

Carrying value < Tax base – tax deductible temporary difference

- The movement in the deferred tax position goes through profit or loss.

	\$'000s
Closing position	X
Opening position	X
Movement	X/(X)

Increase in deferred tax

Dr Income tax expense (SPL)
Cr Deferred tax provision

Decrease in deferred tax

Dr Deferred tax
Cr Income tax expense (SPL)

Example 3 – Tracy (incl. deferred tax)

Tracy purchased an item of property, plant and equipment on 1 January 20X5 for \$5 million. It was estimated that it had a useful economic life of 5 years but according to the tax authority had a 50% tax allowance in its first year and 20% reducing balance thereafter.

Tracy made an accounting profit of \$2m for the year, which is expected to continue unchanged for the next two years.

Income tax rate 20%

Calculate the profits after tax for Tracy for each of the three years ending 31 December 20X5 to 20X7.



	20X5 \$'000s	20X6 \$'000s	20X7 \$'000s
Carrying value			
Tax base			
Temporary difference			
Closing deferred tax			
Opening deferred tax			
Movement			
Statement of profit or loss (extracts)			
	20X5 \$'000s	20X6 \$'000s	20X7 \$'000s
Profit before tax			
Income tax expense			
Current tax			
Deferred tax movement			
Profit for the year			
Statements of financial position (extracts)			
	20X5 \$'000s	20X6 \$'000s	20X7 \$'000s
Non-current liabilities			
Deferred tax			
Current liabilities			
Tax payable			



Example 4 – Accelerated capital allowances

Osborne buys an asset for \$150,000 at the start of the financial year.

The asset has an estimated life of 6 years and an estimated residual value of \$30,000.

Capital allowances are available at a rate of 25% reducing balance and the tax rate is 20%.

Calculate the deferred tax asset/liability to appear in the statement of financial position for the next three years and the debit/credit charged to the tax expense in the statement of profit or loss for the same period.

Example 5 – Revaluations

Clarke bought a property for \$500,000 on 1 January 2013.

On 31 December 2015 the property had a carrying value of \$470,000 and was revalued to \$800,000.

The tax written down value at 31 December 2015 was \$420,000 and the tax rate is 20%.

Explain how the revaluation, including any deferred tax impact, should be dealt with in Clarke's financial statements for the year-ended 31 December 2015.

Losses

If an entity has unused tax losses to carry forward, a deferred tax asset should be recognised to the extent that it is possible that future taxable profits will be available against which the losses will be offset.





Chapter 16

REVENUE FROM CONTRACTS WITH CUSTOMERS (IFRS 15)

IFRS 15 has replaced the previous IFRS on revenue recognition, IAS 18 Revenue and IAS 11 Construction Contracts. It uses a principles-based 5-step approach to apply to contact with customers.

The five steps are as follows:

1. Identification of contracts
2. Identification of performance obligations (goods, services or a bundle of goods and services)
3. Determination of transaction price
4. Allocation of the price to performance obligations
5. Recognition of revenue when/as performance obligations are satisfied

1. Identification of contracts

The contract does not have to be a written one, it can be verbal or implied. In order for IFRS 15 to apply the following must all be met:

- The contract is approved by all parties
- The rights and payment terms can be identified
- The contract has commercial substance
- It is probable that revenue will be collected

2. Identification of performance obligations

If the goods or services that have agreed to be exchanged under the contract are distinct (i.e. could be sold alone) then they should be accounted for separately.

If a series of goods or services are substantially the same they are treated as a single performance obligation.

Illustration – Performance obligations

LiverTech is a computer business that primarily sells computer hardware. As well as selling computers, it also supplies and installs the software to its customers and provides a technical support package over a number of years. The business commonly sells the supply and installation, and technical support in a combined goods and services contract.

The combined goods and services contract has two separate performance obligations, which would need to be separated out and recognised separately.

The installation of software would be recognised once complete and the provision of technical services over the period of the support service.



3. Determination of transaction price

The amount the selling party expects to receive is the transaction price. This should consider the following:

- Significant financing components
- Variable consideration
- Refunds and rebates (paid to the customer!)

Example 1 – Transaction price

Luckers Co. sells a car to a customer for \$10,000, offering interest-free credit for a three-year period. The car is delivered to the customer immediately. The annual market rate of interest on the provision of consumer credit to similar customers is 5%.

What is the transaction price?

4. Allocation of the price

The price is allocated proportionately to the separate performance obligations based upon the stand-alone selling price.

Example 2 – Allocation of price

Richer Co. sells home entertainment systems including a two-year repair and maintenance package for \$10,000. The price of a home entertainment system without the repair and maintenance contract is \$9,000 and the price to renew a two-year maintenance package is \$2,000.

How is the \$10,000 contract price allocated to the separate performance obligations?

Note: Ignore any discounting and time value of money.



5. Recognition of revenue

Once control of goods or services transfers to the customer, the performance obligation is satisfied and revenue is recognised. This may occur at a single point in time, or over a period of time.

If a performance obligation is satisfied at a single point in time, we should consider the following in assessing the transfer of control:

- Present right to payment for the asset
- Transferred legal title to the asset
- Transferred physical possession of the asset
- Transferred the risks and rewards of ownership to the customer
- Customer has accepted the asset.

Example 3 – IFRS 15 (1)

Telephonica sells mobile phones, selling them for “free” when a customer signs up for a 12 month contract. The contract costs the customer \$45 per month.

Explain how the revenue should be recognised in Telephonica’s financial statements

Note: Vodafone sells mobile phones without a monthly contract, selling the handset for \$480. Call and data charges are \$20 per month. Ignore discounting and the time value of money

Example 4 – IFRS 15 (2)

LiverTech is a computer business that primarily sells computer hardware. As well as selling computers, it also supplies and installs the software to its customers and provides a technical support package over two years. The business commonly sells the supply and installation, and technical support in a combined goods and services contract.

The combined goods and services contract sells for \$1,600, but if sold separately the supply and installation is sold for \$1,500 and the technical support for \$500.

If LiverTech sold a combined contract on 1 July 20X7, demonstrate how the transaction would be presented in the financial statements for the year ended 31 December 20X7.

If a performance obligation is transferred over time, the completion of the performance obligation is measured using either of the following methods:

- Output method – revenue is recognised based upon the value to the customer, i.e. work certified.

$$\text{Output method} = \frac{\text{Work certified to date}}{\text{Total contract revenue}}$$

- Input method – revenue is recognised based upon the amounts the entity has used, i.e. costs incurred or labour hours.

$$\text{Input method (cost based)} = \frac{\text{Costs to date}}{\text{Total estimated costs}}$$



Example 5 – Performance obligations over time and the statement of profit or loss (1)

Alex commenced a three year building contract during the year-ended 31 December 20X4 and continued the contract during 20X5. The details of the contract are as follows:

	\$m
Total contract value	45
Costs incurred to date @ 20X5	20
Estimated costs to completion	12
Work certified as completed in 20X5	15
Stage of completion @ 20X5	70%
Profit recognised to date @ 20X4	3.3

Show how this contract would be dealt with in the statement of profit or loss for the year ended 31 December 20X5.

Where not profit can be calculated if contracts spanning more than one accounting period, i.e. it is loss making, then the revenue is limited to the recoverable costs.

Example 6 – Performance obligations over time and the statement of profit or loss (2)

Evelyn commenced a building contract in 20X5 that has seen large increases in future costs to complete. The contract will still be completed on schedule in 20X6. The details from the year ended 31 December 20X5 are as follows:

	\$m
Total contract value	40
Costs incurred to date	25
Estimated costs to completion	20
Stage of completion	45%

Show how this contract would be accounted for in the statement of profit or loss for the year ended 31 December 20X5.

OpenTuition

OpenTuition



As contracts that span more than one accounting period progress, the company is creating an asset for the customer that needs to be recognised in the statement of financial position. The amount to be recognised is as follows:

	\$
Costs incurred to date	X
Recognised profits	X
Recognised losses	(X)
Receivables (amounts invoiced)	(X)
Contract asset/(liability)	<u>X/(X)</u>

Example 7 – Performance obligations over time and the statement of financial position

Noah has a three year contract which commenced on 1 January 20X5. At 31 December 20X5 Noah extracted the following balances from its ledger relating to the contract:

	\$000	\$000
Total contract value		140,000
Cost incurred up to 31 December 20X5:		
Attributable to work completed	52,000	
Inventory purchased for use in future years	<u>8,000</u>	60,000
Progress billing to date		45,000
Cash received		26,500
Other information:		
Expected further costs to completion		48,000

At 31 December 20X5, the contract was certified as 40% complete.

Prepare extracts from the statement of profit or loss and statement of financial position for the year-ended 31 December 20X5.



6. Specifics

Principal vs agent - When a third party is involved in providing goods or services to a customer, the seller is required to determine whether the nature of its promise is a performance obligation to:

- Provide the specified goods or services itself (principal) or
- Arrange for a third party to provide those goods or services (agent)

Repurchase agreements - When a vendor sells an asset to a customer and is either required, or has an option, to repurchase the asset. The legal form here is always a sale followed by a purchase at a later date. The economic substance is more likely to be a loan secured against an asset that is never actually being sold.

Bill and hold arrangements - an entity bills a customer for a product but the entity retains physical possession of the product until it is transferred to the customer at a point in time in the future

Consignments – arises where a vendor delivers a product to another party, such as a dealer or retailer, for sale to end customers. The inventory is recognised in the books of the entity that bears the significant risk and reward of ownership (e.g. risk of damage, obsolescence, lack of demand for vehicles, no opportunity to return them, the showroom-owner must buy within a specified time if not sold to public)



Chapter 17

FOREIGN CURRENCY (IAS 21)

1. Functional currency

If an entity has transactions that are denominated in a currency other than its functional currency then the amount will need to be translated into the functional currency before it is recorded within the general ledger.

The functional currency is the currency of the primary economic environment in which the entity operates. This is deemed to be where the entity generates and expends cash.

Management should consider the following factors in determining the functional currency:

- The currency that dominates the determination of the **sales prices**
- The currency that most influences **operating costs**
- The currency in which an **entity's finances** are denominated is also considered.

2. Recognition and measurement

Record the transaction at the exchange rate in place on the date the transaction occurs (historic rate – HR).

Monetary assets and liabilities are retranslated using the closing rate (CR) at the reporting date, with any gains or losses going through profit or loss.

Non-monetary assets and liabilities are not retranslated at the reporting date, unless carried at fair value, whereby translate at the rate when fair value was established.

Note: No specific guidance is given as to where any exchange differences are recorded within profit or loss. The general accepted practice is:

- Trading transaction – operating costs
- Financing transaction – financing costs

Example 1 – Functional currency (1)

Jones Inc. has its functional currency as the \$USD.

It trades with several suppliers overseas and bought goods costing 400,000 Dinar on 1 December 2017. Jones paid for the goods on 10 January 2018. Flower's year-end is 31 December.

The exchange rates were as follows:

1 December 2017	4.1 Dinar : \$1USD
31 December 2017	4.3 Dinar : \$1USD
10 January 2018	4.4 Dinar : \$1USD

Show how the transaction would be recorded in Jones's financial statements.





Chapter 18

FAIR VALUE (IFRS 13)

IASB has adopted a fair value method to measure assets and liabilities in its IFRS accounting standards because the historic cost convention was not consistent with the underlying qualitative characteristic of relevance.

The issue was there was no definition of what fair value actually was, until IFRS 13 was created.

Fair value – The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

IFRS 13 adopts a hierarchical approach to measuring fair value, whilst giving consideration to the principal market, being the largest market in which an asset/liability is traded. It also considers the highest and best use of an asset.

Level 1 inputs

Level 1 inputs are quoted prices in active markets (frequency and volume) for identical assets or liabilities that the entity can access at the measurement date.

A quoted market price in an active market provides the most reliable evidence of fair value and is used without adjustment to measure fair value whenever available, with limited exceptions.

Level 2 inputs

Level 2 inputs are inputs other than quoted market prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.

Level 2 inputs include:

quoted prices for similar assets or liabilities in active markets

quoted prices for identical or similar assets or liabilities in markets that are not active

inputs other than quoted prices that are observable for the asset or liability, for example interest rates and yield curves observable at commonly quoted intervals

Level 3 inputs

Level 3 inputs are unobservable inputs for the asset or liability and covers the scenarios whereby there is little, if any, market activity.

An entity develops unobservable inputs using the best information available in the circumstances, which might include the entity's own data, taking into account all information about market participant assumptions that is reasonably available.





Chapter 19

EARNINGS PER SHARE (IAS 33)

1. Basic Earnings per Share

$$\text{Basic EPS} = \frac{\text{Profit attributable to ordinary shareholders of the parent}}{\text{Weighted average number of shares}}$$

If the number of shares has changed during the period the following assumptions are made regarding the weighted average number of shares:

Full price issue	Normal weighted average calculation
Bonus issues	Assume that the bonus shares have always been in issue (and therefore alter the comparative EPS amount)
Rights issue	Assume that the shares issued are a mix of bonus and full price shares. For the bonus element assume that they have always been in issue and therefore adjust the comparative

If bonus issues or rights issues occur after the reporting date, but before the date of approval of the accounts the EPS should be calculated based on the number of shares following the issue.

Example 1 – Basic EPS

Ruth makes up its accounts to 30 June each year. On 1 July 20X5 Ruth has 500 million ordinary shares in issue.

Profits for the year to 30 June 20X6 were \$250m. There were no preference shares in issue.

Calculate the basic earnings per share assuming:

- (a) Share capital has not changed during the year
- (b) An issue of 50 million new shares at full market price on 1 August 20X5.
- (c) A 1 for 4 bonus issue occurring on 1 November 20X5.
- (d) A 1 for 5 rights issue on 1 February 20X6 held at \$1.25. The price of a share immediately before the rights issue was \$1.40.

Example 2 – Multiple share issues and prior year comparatives

Ernie had earnings of \$750,000 for the year-ended 31 March 2019. There were 2,000,000 \$1 equity shares in issue on 1 April 2018, and a new issue of 3,000,000 shares at full market price was carried out on 30 September 2018. A bonus issue of one new share for every two shares held was issued on 1 December 2018.

The EPS figure reported for the year-ended 31 March 2018 was 15.5c.

Calculate the basic EPS for Ernie for the year-ended 31 March 2019, and restate the comparative figure for 31 March 2018.



2. Diluted earnings per share

This is calculated where potential ordinary shares have been outstanding during the period which would cause EPS to fall if exercised (dilutive instruments).

The earnings should be adjusted by adding back any costs that will not be incurred once the dilutive instruments have been exercised. This will include for post-tax interest saved on convertible debt.

The number of shares will be adjusted to take account of the exercise of the dilutive instrument. This means that adjustment is made:

For convertible instruments By adding the maximum number of shares to be issued in the future

For options By adding the number of effectively "free" shares to be issued when the options are exercised

Example 3 – Diluted EPS

Flanagan makes up his accounts to 31 December each year and has calculated the basic EPS based on actual shares of 1,000 million and earnings of \$500m, for the year ended 31 Dec 20X5.

Convertible debentures

On 31 December 20X6 Flanagan had in issue of \$10m of 5% convertible loan stock.

The loan stock is convertible at the following dates with the following terms:

31 Dec 20X6 125 shares for every \$100 of loan stock

31 Dec 20X7 120 shares for every \$100 of loan stock

The tax rate is 20%

Share options

Flanagan also granted 100m options at the same date. The option price is \$2.50 but the average fair value of a share is \$4.00.

Calculate the fully diluted EPS for the year to 31 December 20X5.



ANALYSIS AND INTERPRETATION

Chapter 20

FINANCIAL PERFORMANCE (PROFITABILITY)

Gross profit margin

Gross margin (%)

$$\frac{\text{Gross profit}}{\text{Revenue}} \times 100\%$$

An increase in gross profit margin indicates that variable costs, raw materials, labour, power etc are not rising as quickly as selling prices, whilst a decrease will indicate the opposite.

Changes in the gross profit margin over time should be analysed further to identify the cause: has the company introduced new products? Is it cutting prices to increase market share? Was it unable to pass on inflationary price increases?

Operating profit margin

Operating profit margin (%)

$$\frac{\text{PBIT}}{\text{Revenue}} \times 100\%$$

This will differ from the gross profit margin in that selling, general and administrative expenses and depreciation are deducted. An analysis of the causes of changes in this percentage might reveal that the company's other costs are increasing/decreasing at a greater rate than sales.

Return on capital employed

Return on capital employed (%)

$$\frac{\text{PBIT}}{\text{Net debt + equity}} \times 100\%$$

This measures the level of returns a business has made using the capital it has within it. It allows for comparison of overall performance year on year as well as allowing comparison to an entity in a similar industry of different size.

Net asset turnover

Asset turnover (# times)

$$\frac{\text{Revenue}}{\text{Capital employed*}}$$

* Capital employed = shareholders' funds + interest bearing debt.



Non-current asset turnover

$$\frac{\text{Revenue}}{\text{Non-current assets}}$$

This is the overall measure of the efficiency of a company in generating sales from its investment in non-current assets. The minimum investment in assets to generate the maximum revenue is an indication of efficiency. However, it may in fact deteriorate in the short term if a company is replacing heavily depreciated assets with new equipment.

Some factors to consider:

- Timing of Sales
- Asset efficiency vs profitability
- Asset valuation policies

Example 1 – ROCE

The following extracts are from Hassan's financial statements:

	\$
Profit before interest and tax	10,200
Interest	(1,600)
Tax	(3,300)
Profit after tax	<u>5,300</u>
Share capital	20,000
Reserves	<u>15,600</u>
	35,600
Loan liability	<u>6,900</u>
	42,500

What is Hassan's return on capital employed?

- A** 15%
- B** 29%
- C** 24%
- D** 12%



Example 2 – Financial performance

Archer Co is a retailer and trades through its stores on the high street, selling high quality goods. The company has recently been suffering from rising costs, that it has been unable to pass on to its customers. In response to the number of people shopping via the Internet, Archer Co has implemented a cost cutting strategy in the prior year, and in the current year asked shareholders for funds to help reduce its debt burden. The following financial information for the current year is available:

Statement of profit and loss for the year ended 31 March 2019

	2019 \$'000s	2018 \$'000s
Revenue	42,000	45,000
Cost of sales	(19,000)	(17,000)
Gross profit	23,000	28,000
Operating expenses	(10,000)	(17,000)
Operating profit	13,000	11,000
Finance costs	(700)	(1,000)
Profit before tax	12,600	10,000
Income tax expense	(3,150)	(2,500)
Profit for the year	9,450	7,500

(a) Calculate the following ratios for the years ending 31 May 2019 and 31 May 2018:

- Gross margin**
- Operating margin**

(b) Using the information provided and the ratios calculated above, comment on the comparative performance for the two years ended 31 May 2019 and 2018.





Chapter 21

FINANCIAL POSITION

1. Liquidity

The ability of a company to pay its obligations as and when they fall due (its liquidity) is a major concern of any credit analysis. Short term liquidity can be assessed by comparing current assets with current liabilities in a variety of forms:

$$\text{Working Capital} = \text{Current Assets} - \text{Current Liabilities}.$$

A working capital surplus represents a cushion of protection for current creditors; it indicates the amount by which the value of current assets could decrease still leaving enough to repay current liabilities from the sale of current assets.

The optimum amount of working capital varies considerably from company to company and from industry to industry, thus the nature of the company's business and the quality of its assets must be considered. Companies functioning within industry sectors with short production/sales cycles (e.g. supermarkets) can generally function satisfactorily with a much smaller amount of working capital than those with a long production cycle (e.g. heavy engineering).

2. Current ratio

$$\frac{\text{Current assets}}{\text{Current liabilities}}$$

A current ratio of over one indicates that a company has a higher level of current assets than current liabilities and should, therefore, be in a position to meet its short term obligations as and when they fall due. However, some companies function adequately on current ratios of less than one whilst others need a much higher ratio. Generally the more liquid the current assets are the higher this ratio will be.

Trends are difficult to analyse but generally higher ratios indicate greater liquidity. However, an increase may reflect a high level of unsaleable stock or overdue receivables whereas a decrease may result from greater efficiency.

Some factors to consider:

- Asset quality
- Seasonality



3. Quick ratio (acid test)

$$\frac{\text{Current assets} - \text{inventory}}{\text{Current liabilities}}$$

This quick ratio shows how easily a company can meet its current obligations using funds raised from quick assets (those assets which can be converted quickly into cash).

A comparison of the quick ratio and current ratios which shows increases in both, but with the current ratio increasing more, would indicate that the company has been building up stock.

4. Working capital

Inventory days

$$\frac{\text{Inventory}}{\text{Cost of sales}} \times 365$$

Shows how long a business is holding its inventory. A higher number of days inventory might indicate holdings of obsolete or unsaleable inventory, but it might also signify a purchase of raw materials now in anticipation of an increase in price later.

Trade receivables collection period

$$\frac{\text{Trade receivables}}{\text{Revenue}} \times 365$$

Providing revenue is evenly spread throughout the year the ratio will indicate how effectively debts are being collected.

An increase in the ratio of receivables to revenue could, providing the proportion of cash sales has not increased, indicate one of the following:-

Receivables are being given or are taking longer to pay. What are the terms of trade?

The total receivables figure includes long outstanding debts. Should provisions be made?

Trade payables payment period

$$\frac{\text{Trade payables}}{\text{Cost of sales}} \times 365$$

If purchases are spread evenly throughout the year, this ratio will show the length of credit the company is taking. An increase in the ratio may indicate that more reliance is being placed upon the payables to finance the business. A drop in days may indicate that a company is taking cash discounts or may indicate suppliers are cutting credit terms because of the company's decreased creditworthiness.



5. Solvency/gearing/risk

Gearing ratio

$$\frac{\text{Net debt}}{\text{Equity}}$$

An increase in the gearing ratio indicates that either borrowings are increasing faster than equity, or equity is falling more quickly than borrowings. In extreme cases, borrowings may be increasing while equity falls.

In the first case, this may be simply because the profit potential of any increased borrowing has not yet been realised, or that the increase in profitability arising from the use or the increase in borrowings is not being retained within the business.

Interest cover

$$\frac{\text{PBIT}}{\text{Interest payable}}$$

Indicates the number of times profits exceed interest expense. This may indicate severe financial difficulties or that borrowings are too high for the company to support. Is the current year's profitability exceptional?

It is important to note that this is a ratio based on profitability not cashflow which would be a better indicator of company's ability to pay interest.

Example 1 – Working capital

Xena has the following working capital ratios:

	20X9	20X8
Current ratio	1.2:1	1.5:1
Receivables days	75 days	50 days
Payables days	30 days	45 days
Inventory turnover	42 days	35 days

Which of the following statements is correct?

- A Xena's liquidity and working capital has improved in 20X9
- B Xena is receiving cash from customers more quickly in 20X9 than in 20X8
- C Xena is suffering from a worsening liquidity position in 20X9
- D Xena is taking longer to pay suppliers in 20X9 than in 20X8



Example 2 – Financial performance and working capital

SAF has experienced a period of rapid expansion in the last 6 months following the launch of a new product on 1 July 20X2. The following information is available from the management accounts of SAF:

	<i>6 months to 31 December 20X2</i>	<i>6 months to 30 June 20X2</i>
	\$000	\$000
Inventories at period end	1,220	460
Receivables at period end	1,715	790
Cash and cash equivalents at period end	-	150
Trade payables at period end	1,190	580
Short-term borrowing at period end	250	-
Revenue for the period	3,100	2,000
Cost of sales for the period	2,420	1,450

Analyse the financial performance and working capital position of SAF, including the calculation of five relevant ratios.



Chapter 22

INVESTOR ANALYSIS

Dividend Cover

$$\frac{\text{Profit for the year}}{\text{Dividends}} \quad (\# \text{ times})$$

Dividend Yield

$$\frac{\text{Dividends} \times 100\%}{\text{Share price}} \quad (\%)$$

Price/earnings ratio

$$\frac{\text{Price per share}}{\text{Earnings per share}}$$

Note: EPS can also be calculated but that is dealt with in a previous chapter because it is a ratio with its own accounting standard.

Example 1 – Investor ratios

Morgan Co is a listed company and has 50c equity share capital of \$20m in issue.

The company paid a dividend per share of 10.5c in its most recent financial year and the share price at the reporting date was \$1.20. The additional financial information is also available to investors:

Statement of profit and loss

	2019
	\$'000s
Profit before tax	28,350
Income tax expense	(4,600)
Profit for the year	<u>22,680</u>

Calculate each of the following investor ratios for Morgan Co:

Dividend cover

Dividend yield

P/E ratio

EPS





GROUP ACCOUNTS

Basic principles



Single entity concept

- P Ltd and S Ltd – separate **legal** entities
- P Group Ltd – one single entity, prepare accounts using **substance**

Control and ownership

- Control (power to direct activities) – 100%P + 100%S
- NCI - Ownership

A **parent** is an entity that has one or more subsidiaries.

A **subsidiary** is an entity which is controlled by another entity (known as the parent).

The key concept in determining whether or not an investment constitutes a subsidiary is that of **control**.

Control is the power to govern the financial and operating policies of an entity so as to obtain benefit from its activities.

Control is usually achieved by the purchase of more than 50% of a company's equity share capital.

IFRS 10 Consolidated Financial Statements defines control and tells us how to consolidate.

A parent/subsidiary relationship can exist even where the parent owns less than 50% of the voting power of the subsidiary since the key to the relationship is control and the power to direct the activities. Other situations where control exists are when the investor:

- Can exercise the majority of the voting rights in the investee
- Is in a contractual arrangement with others giving control
- Holds < 50% of the voting rights, but the remainder are widely distributed
- Holds potential voting rights which will give control





Chapter 23

CONSOLIDATED STATEMENT OF FINANCIAL POSITION

1. Subsidiary

A subsidiary is an entity that is controlled by another entity (parent).

An entity has control over an entity when it has the power to direct the activities, which is assumed to be when the entity has > 50% of the voting rights.

The parent company must prepare consolidated financial statement if it has control over one or more subsidiaries.

The underlying principles of consolidation are:

- Substance over legal form
- Control and ownership

2. Basic consolidation

2.1. Basic steps

100% P + 100% S assets and liabilities, ignoring the investments in subsidiary

100% P share capital and share premium only (reporting to parent's shareholders)

Retained earnings (balancing figure)

Example 1 – Basic consolidation

Peter acquired 100% of the equity share capital of Steven on 31 December 20X4 for \$1,000,000.

The financial statements of the two companies at that date were as follows:

	<i>Peter</i>	<i>Steven</i>
	\$000	\$000
Investment in Steven Co	1,000	-
Other assets	1,500	1,200
Total assets	<u>2,500</u>	<u>1,200</u>
Equity share capital	1,000	250
Retained earnings	<u>1,100</u>	<u>750</u>
	2,100	1,000
Liabilities	400	200
Total equity and liabilities	<u>2,500</u>	<u>1,200</u>

Prepare the consolidated statement of financial position for the Peter Group at 31 December 20X4.



Example 2 – Basic consolidation (continued)

Following Peter's acquisition of the 100% of Steven's equity share capital of Steven on 31 December 20X4, both companies continued to trade. The financial statements of the two companies at the end of the following year 31 December 20X5 were as follows:

	<i>Peter</i>	<i>Steven</i>
	<i>\$000</i>	<i>\$000</i>
Investment in Steven Co	1,000	-
Other assets	1,900	1,450
Total assets	<u>2,900</u>	<u>1,450</u>
Equity share capital	1,000	250
Retained earnings	1,400	900
	<u>2,400</u>	<u>1,150</u>
Liabilities	500	300
Total equity and liabilities	<u>2,900</u>	<u>1,450</u>

Prepare the consolidated statement of financial position for the Peter Group at 31 December 20X5.

3. Non-controlling interest

Control is exerted through a shareholding of greater than 50%, so therefore it is not always necessary to fully own a subsidiary.

Shareholdings of 75% will still give the parent the power to direct the activities of the subsidiary and therefore it must prepare consolidated financial statements.

As the parent's 75% holding still maintains control, the assets and liabilities of the subsidiary are consolidated **100% on a line-by-line basis**.

It is necessary to account for 25% ownership interest in the subsidiary which is referred to as the non-controlling interest. It is shown in the equity section of the consolidated statement of financial position.

The non-controlling interest is measured using either of the following methods:

- Proportionate share of net assets
- Fair value



Example 3 – Non-controlling interest

Pierre acquired 80% of Stefan's equity share capital on 31 December 20X4 when Stefan's retained earnings were \$750,000.

The financial statements of the two companies at the end 31 December 20X5 were as follows:

	<i>Pierre</i>	<i>Stefan</i>
	<i>\$000</i>	<i>\$000</i>
Investment in Stefan Co	800	-
Other assets	1,900	1,450
Total assets	<u>2,700</u>	<u>1,450</u>
Equity share capital	1,000	250
Retained earnings	1,200	900
	<u>2,200</u>	<u>1,150</u>
Liabilities	500	300
Total equity and liabilities	<u>2,700</u>	<u>1,450</u>

Prepare the consolidated statement of financial position for the Pierre Group at 31 December 20X5 assuming the non-controlling interest is measured using the proportionate share of net assets method

4. Goodwill

On acquisition of a subsidiary, the parent will usually pay more for the subsidiary than the value of the net assets (assets less liabilities). Why?

- Customer loyalty
- Good reputation

The difference between what the parent pays and what the net assets are truly worth is referred to as goodwill.

Example 4 – Goodwill

A parent company buys 75% of the equity shares in a subsidiary company for \$156,000.

The remaining shares were valued at \$52,000 and the net assets at acquisition were \$170,000.

Calculate the goodwill arising on acquisition assuming that:

- **Non-controlling interest is measured using the proportionate share of net assets method**
- **Non-controlling interest is measured using the fair value method.**



Example 5 – Basic consolidation (revision)

On 1 January 20X3 Gasta Co acquired 75% of the share capital of Erica Co for \$1,380,000. The retained earnings of Erica Co at that date were \$480,000. Erica Co's share capital has remained unchanged since the acquisition.

The following draft statements of financial position for the two companies have been prepared at 31 December 20X9.

	<i>Gasta Co</i>	<i>Erica Co</i>
	<i>\$000</i>	<i>\$000</i>
Investment in Erica Co	1,380	0
Other assets	4,500	2,400
Total assets	<u>5,880</u>	<u>2,400</u>
Equity share capital	2,000	1,000
Retained earnings	2,040	660
	<u>4,040</u>	<u>1,660</u>
Liabilities	1,840	740
Total equity and liabilities	<u>5,880</u>	<u>2,400</u>

The non-controlling interest (NCI) was valued at \$450,000 as at 1 January 20X3.

Required:

- (a) Calculate the goodwill arising on acquisition of Erica
- (b) Calculate the non-controlling interest at 31 December 20X9
- (c) Calculate the following figures which will be reported in Gasta's consolidated statement of financial position as at 31 December 20X9.
 - (i) Investment
 - (ii) Other assets
 - (iii) Share capital
 - (iv) Retained earnings
 - (v) Liabilities

4. Other reserves (e.g. revaluation reserve)

Each reserve has a separate calculation still based on ownership so the calculation is the same as for group retained earnings

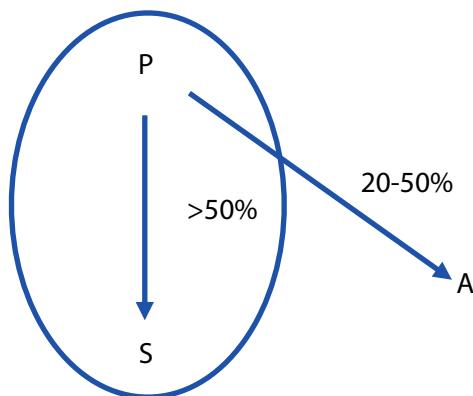
Group revaluation reserve

100% P	X
Add: P's % of S's post acq ⁿ revaluation reserve	X
	<u>X</u>



5. Workings

W1) Group Structure



W2) Net assets of subsidiary

	<i>At reporting date</i>	<i>At acquisition</i>	<i>Post acquisition</i>
Equity shares	X	X	
SP	X	X	
Ret. earnings	X	X	
	X	X	X

W3) Goodwill

FV of consideration (shares/cash)	X
NCI at acquisition	X
	X
FV of net assets at acquisition (W2)	(X)
Goodwill at acquisition	X

W4) Non-controlling interests

NCI @ acquisition (W3)	X
Add: NCI% x S's post-acq ⁿ profits (W2)	X
	X

W5) Group retained earnings

100% P	X
Add: P's % of S's post acq ⁿ retained earnings (P's% x (W2))	X
	X



Example 6 – Workings

Matthews purchased 80% of Jones for \$600,000 two years ago when Jones's retained earnings showed a balance of \$100,000.

	<i>Matthews</i>	<i>Jones</i>
	<i>\$000</i>	<i>\$000</i>
Non-current assets	1,000	500
Investment in Jones	600	-
Current assets	800	600
Total assets	<u>2,400</u>	<u>1,100</u>
Equity share capital (\$1)	500	200
Retained earnings	800	400
	<u>1,300</u>	<u>600</u>
Liabilities	1,100	500
Total equity and liabilities	<u>2,400</u>	<u>1,100</u>

Additional information:

Matthews measures the non-controlling interest using the fair value method.

The fair value of Jones's equity shares acquired was \$200,000 at acquisition

Prepare the consolidated statement of financial position for the Matthews group for the year-ended 31 December 20X5.



6. Adjustments – group and subsidiary

6.1. Intra-company balances

- Remove the payable
- Remove the receivable

6.2. Cash in transit

Step 1 Deal with cash in transit first (adjust receiver's books to assume they have recorded the cash)

Step 2 Remove the intra-company trade receivable and payable

Illustration – Cash in transit

P has an intra-company trade receivable of \$1,500 at the year-end due from S. This does not agree with the corresponding \$1,000 trade payable in S due to a cheque of \$500 sent by S immediately prior to the year-end, which P did not receive until after the start of the new accounting year.

To account for the cash in transit and intra-company balances we need to:

- 1) Record the cash in transit in the group accounts

DR Bank \$500

CR Receivables \$500

- 2) Eliminate the equal intra-company balances

DR Payables \$1,000

CR Receivables \$1,000

6.3. Inventory in transit

Dr Inventory (SFP) X

Cr Payables (SFP) X

6.4. Unrealised profits

Inventory PUP - Need to remove the intra-group profit included in inventory held @ year-end (cost structures)

Cr Inventory (SFP) X

Dr Retained earnings (of seller) X

If S is seller → Adjust (W2)

If P is seller → Adjust (W5)



Illustration – Unrealised profits

P sells \$100 goods to S at \$125 and S has not sold the goods on by the end of the year.



Example 7 – Unrealised profits

Statements of financial position as at 31 December 20X5

	<i>James</i> \$'000	<i>Molly</i> \$'000
Non-current assets		
PPE	900	500
Investment in Molly	800	-
Current Assets	700	600
	<hr/> 2,400	<hr/> 1,100
Share Capital	500	200
Retained earnings	800	400
Current liabilities	1,100	500
	<hr/> 2,400	<hr/> 1,100

Additional information:

James bought 80% of the equity shares in Molly for \$800,000 when the retained earnings were \$150,000.

Non-controlling interest is measured using the fair value method.

The fair value of the non-controlling interest was \$200,000 at the acquisition date.

During the year Molly sold goods to James at \$120,000 based on a mark-up of 20%. Half of the goods remain in inventory at the year-end.

Prepare the James Group consolidated statement of financial position as at 31 December 20X5.



Non-current asset PUP - Need to remove the intra group profit on intra -company transfers of non-current assets

Cr PPE (CSFP) X
Dr Retained earnings (of seller) X

If S is seller → Adjust (W2)

If P is seller → Adjust (W5)

Illustration – Non-current assets PUPs

A parent company sold an item of PPE for \$250,000 to its subsidiary on the last day of the reporting period, when its carrying value was \$200,000.

The intra-group profit of \$50,000 needs to be removed so that the PPE is held at the carrying value to the group of £200,000. An adjustment would be required as follows:

DR Retained earnings (parent – (W5)) \$50,000
CR PPE (CSFP) \$50,000

Fair value adjustments (IFRS 3)

Bring in FV of identifiable assets and liabilities on a line by line basis into the group SFP (PPE, inventory, contingent liabilities)

Adjust S's net assets (W2) @ SFP date and @ acquisition column.

Adjust S's net assets (W2) @ acqⁿ column (extra depⁿ, sale of inventory)

Illustration – Fair value adjustment (PPE)

A parent company acquires a subsidiary at the start of the reporting period, where the fair value of the PPE is \$50,000 higher than its book value and the remaining life of the PPE is 10 years.

The fair value adjustment is recorded within the workings at the end of the first year as follows:

(W2) Net assets of the subsidiary

	At reporting date	At acquisition	Post acquisition
Equity shares	X	X	
Ret. earnings	X	X	
FV (PPE)	50	50	
Extra dep ⁿ .	(5)		
	X	X	X

And the fair value is also reflected on the face of the statement of financial position as follows:

Non-current assets

	\$000s
Property, plant and equipment (100% P + 100% S + 50 – 5)	X



Illustration – Fair value adjustment (contingent liability)

A parent company acquires a subsidiary at the start of the reporting period, and there is a contingent liability of \$100,000 disclosed in the notes to the subsidiary's accounts.

The contingent liability is recorded at fair value within the workings at the end of the first year as follows:

(W2) Net assets of the subsidiary

	<i>At reporting date</i>	<i>At acquisition</i>	<i>Post acquisition</i>
Equity shares	X	X	
Ret. earnings	X	X	
Contingent liability	(100)	(100)	
	X	X	X

And the fair value is also reflected on the face of the statement of financial position as follows:

Current liabilities

	\$000s
Contingent liability	100

7. Other issues

7.1. Consideration

A parent may acquire a controlling interest in a subsidiary in other fashions as opposed to just a cash payment. Other considerations are as follows:

- Share for share exchange
- Deferred cash consideration
- Contingent consideration

7.2. Share for share exchange

- Calculate the number of subsidiary shares acquired
- Calculate the number of P shares issued
- Value the P shares issued
- Record the journal entry



Example 8 – Share exchange

Harry acquired 80% of the 10 million ordinary \$1 shares of Sally by offering a share exchange of one for every four shares acquired. The fair value of Harry's shares is \$3 per share.

Calculate the cost of investment for the acquisition and prepare the journal entry to record the share issue.

7.3. Deferred consideration

A parent may agree to pay cash in the future following the acquisition of the subsidiary. This deferred consideration is recorded on acquisition at present value.

Example 9 – Deferred consideration

Pony acquired 80% of the 30 million \$1 equity shares of Star on 1 January 20X5. The consideration was through the offer of a share exchange of two shares issued for every three shares acquired and a cash payment of \$1 per share payable on 31 December 20X5. The fair value of the Pany's equity shares was \$2 at 1 January 20X5.

The present value of \$1 received in one year's time is \$0.91 at a rate of 10%.

Calculate the cost of the investment in Star at 1 January 20X5

The deferred consideration needs to be unwound to its final value and is done so using the interest rate originally applied to discount back the original entry and is recorded as follows:

Dr Finance cost

Cr Deferred consideration liability

NOTE: The adjustment does not impact the fair value of consideration.



7.4. Mid-year acquisitions

Calculate the subsidiary's retained earnings at acquisition, assuming subsidiary profits in the year accrue evenly.

Illustration – Mid-year acquisition

Richard acquired 80% of Andy's equity share capital on 1 August 20X5. Both have a year end of 31 December 20X5.

Andy's retained earnings at the end of the year were \$600,000 and its profit for the year was \$120,000.

Assuming the profit accrued evenly during the year then the Andy's retained earnings figure at 1 August 20X5 is calculated as follows:

$$\$600,000 - (5/12 \times \$120,000) = \$540,000$$

7.5. Uniform accounting policies

Subsidiary must adopt the parents accounting policies in the group accounts. Accounted for by adjusting the value of assets/liabilities and (W2).

7.6. Coterminal year-ends

Financial statements within three months of the parents year-end can be used and adjusted for any significant events.

7.7. Non-consolidation

Subsidiaries are not consolidated if it is:

- Held for sale in accordance with IFRS 5 and
- Operating under long-term restrictions such that the parent company cannot exercise control





Chapter 24

GROUP STATEMENT OF PROFIT AND LOSS

1. Basic consolidation

Example 1 – Basic consolidation (revision)

Keswick Co acquired 80% of the share capital of Derwent Co on 1 June 20X5.

The summarised draft statements of profit or loss for Keswick Co and Derwent Co for the year ended 31 May 20X6 are shown below:

	<i>Keswick</i> \$000	<i>Derwent</i> \$000
Revenue	8,400	3,200
Cost of sales	(4,600)	(1,700)
Gross profit	3,800	1,500
Operating expenses	(2,200)	(960)
Profit before tax	1,600	540
Tax	(600)	(140)
Profit for the year	1,000	400

Prepare the Keswick group consolidated statement of profit or loss for the year ended 31 May 20X6.



Consolidated statement of profit and loss and other comprehensive income

	X/12			
	P	S	Adj.	Group
Revenue	X	X	(X)	X
COS	(X)	(X)	X	
-PUP (Inventory)	(X)	(X)		
-FV adj (extra dep ⁿ)		(X)		
Gross profit				X
Dist costs	(X)	(X)		(X)
Admin exp.	(X)	(X)		
-Impairment		(X)		(X)
Finance cost	(X)	(X)	X	(X)
Investment income	X	X	(X)	X
-Dividend from S/A	(X)			
Associate (P's % x A's PFY) - impairment				X
Profit before tax				X
Taxation	(X)	(X)		(X)
PFY		X		X
Revaluation gain	X	X		X
Associate				X
TCI		X		X
		Parent (β)		X
		NCI = NCI% x S's TCI		X



2. Basic consolidation (mid-year acquisition)

Example 2 – Basic consolidation (mid-year acquisition)

Statements of profit or loss for the year-ended 31 December 20X5

	<i>Vader</i>	<i>Maul</i>
	\$'000	\$'000
Revenue	1,645	1,280
Cost of sales	(1,205)	(990)
Gross profit	440	290
Distribution costs	(100)	(70)
Administrative expenses	(90)	(50)
Profit before interest and tax	250	170
Finance costs	(55)	(30)
Investment income	10	
Profit before tax	205	140
Taxation	(35)	(28)
Profit for the year	170	112

Additional information:

1. On 1 July 20X5, Vader acquired 80% of the equity shares of Maul. It is the group policy to measure the non-controlling interest at acquisition at fair value.
2. Maul declared a dividend during the year of \$10,000.
3. An impairment review at the reporting date revealed the goodwill in Maul to be impaired by \$20,000
4. Assume that the profits accrue evenly.

Prepare a consolidated statement of profit or loss for the Vader group for the year-ended 31 December 20X5



3. Adjustments

Intra-group trading transactions

E.g. sales, loans/debenture interest and management charges

- Remove the expense – adjustment column
- Remove the income – adjustment column

Unrealised profits

PUP adjustment on goods unsold at year-end (cost structures) by increasing C'o'S in seller's column.

Fair value adjustment

Any additional, annual depreciation on the fair value increase of S's net assets is adjusted through C'o'S in S's column.

Example 3 – Unrealised profits

Statement of profit or loss for the year ended 31 December 20X5

	<i>Gary</i>	<i>Nick</i>
	<i>\$000</i>	<i>\$000</i>
Revenue	120,000	90,000
Cost of sales	(70,000)	(40,000)
Gross profit	<u>50,000</u>	<u>50,000</u>
Operating expenses	(20,000)	(35,000)
Profit from operations	30,000	<u>15,000</u>
Finance cost	(2,000)	(500)
Profit before tax	28,000	14,500
Income tax expense	(6,000)	(3,000)
Profit for the year	22,000	11,500

Additional information:

- Gary acquired 80% of Nick on 1 January 20X5. Goodwill on acquisition has been impaired by \$1m during the year and should be charged to operating expenses. Full goodwill method
- During the year Nick sold \$10m goods to Gary at a mark-up of 25% on cost. One quarter of those goods are in inventory at the year end.

Prepare the Gary Group consolidated statement of profit or loss for the year to 31 December 20X5.



4. Group disposals

A group structure can change if the parent company sells the shares in an entity (subsidiary). At this level only the full disposal of a subsidiary is examinable, whereby the parent has control and then following the disposal of shares no longer owns any further shares.

Control -> no control

1. Calculate a group profit or loss on disposal of the subsidiary.
2. The revenues and costs of the subsidiary must be consolidated up to the date of the disposal

(W) Group profit/loss on disposal

	\$m
Proceeds	X
Add: non-controlling interest	X
Less: net assets at disposal	(X)
Less: goodwill	(X)
Group profit or loss on disposal	<hr/> <hr/> X

Example 4

Socks owned 90% of Mogs before it decided to sell all of its investment on 31 December 2017 for \$200 million. The non-controlling interest at that date was \$15 million.

The goodwill on acquisition was \$38 million and the net assets at the date of disposal were \$150 million.

Calculate the group profit on disposal that will appear in the group financial statements of Socks group for the year-ended 31 December 2017.





Chapter 25

ASSOCIATES (IAS 28)

An associate is where an entity has significant influence over the associated company.

Significant influence is the power to participate in the financial and operating policy decisions. It is presumed that an investment of between 20% and 50% indicates the ability to significantly influence the investee.

1. Group Statement of financial position – ‘Investment in associate’

The investment in associate is calculated as follows:

	\$
Cost of investment in A	X
Add: % of A's post acquisition reserves	X
Less: impairment of goodwill	(X)
	<hr/>
	X

Example 1 – Associate (SFP)

Penny bought 30% of the equity share capital of Alex on 1 January 20X5 for \$250,000. Alex's profits for the year were \$170,000.

An impairment review was carried out at the end of the year and the investment in Alex was found to be impaired by \$20,000.

Calculate the investment in associate to appear in Penny's financial statements at 31 December 20X5.

2. Group Statement of profit or loss – ‘Share of profit of associate’

A share of profit of associate is calculated as shown below and shown immediately before profit before tax.

% of A's profit for the year	X
Less: goodwill impaired during the year	(X)
	<hr/>
	X

3. Adjustments - group and associate

Trading transactions – do not eliminate the balances

Unrealised profits – adjust for P's% of any PUP



4. IAS 28 Associates

Other situations where significant influence exists are when the investor:

- Representation on the board
- Participation in policy making process
- Material transaction between the two entities
- Interchange of managerial personnel
- Provision of essential technical information



SOLUTIONS

Chapter 1

Answer to example 1 – Qualitative characteristics

Answer B – For information to faithfully represent the transaction it needs to be complete, free from bias and neutral.

Answer to example 2 – Framework

IAS 2 Inventories

Definition (asset) - A present economic resource controlled by the entity as a result of past events An economic resource is a right that has the potential to produce economic benefits.

Measurement - Valued at lower of cost and net realisable value

IAS 16 Property, plant and equipment

Definition (asset) - A present economic resource controlled by the entity as a result of past events An economic resource is a right that has the potential to produce economic benefits.

Definition (depreciation) - Decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims

Measurement – Historic cost or fair value (revaluation model)

Disclosure – Gains on revaluation recognised through profit or loss (prudence)

Answer to example 3 - Measurement

Answer B

Chapter 2

Answer to example 1 - Regulatory Framework

Answer A

Answer to example 2 – Regulatory bodies

Answer C



Chapter 3

Answer to example 1 – Statement of profit and loss, and statement of financial position

Statement of financial position as at 31st December 2017

	\$	\$
ASSETS		
Non-current assets		
Property, plant and equipment (W)	12,320	
Current assets		
Inventories (W)	4,000	
Trade and other receivables	9,290	
Cash and cash equivalents	3,125	
	<hr/>	<hr/>
	16,415	
Total assets	<hr/>	28,735
EQUITY AND LIABILITIES		
Equity		
Equity shares (\$1)	5,000	
Retained earnings (5,835 + 13,040)	<hr/>	18,875
Total equity	<hr/>	23,875
Non-current liabilities		
Debentures	1,000	
Current liabilities		
Trade and other payables	2,360	
Tax payable	<hr/>	1,500
	<hr/>	3,860
Total equity and liabilities	<hr/>	28,735

Statement of profit and loss for the year ended 31st December 2017

	\$
Revenue	66,980
Cost of sales (1,800 + 3,930 + 38,760 + 800 (W) + 480 (W) – 4,000 (W))	<hr/>
Gross profit	(41,770)
	<hr/>
Distribution expenses (1,800 + 3,130)	25,210
Administrative expenses (1,800 + 3,790)	<hr/>
Operating profit	(4,930)
	<hr/>
Finance costs (200)	(5,590)
Investment income	<hr/>
Profit before tax	14,690
	<hr/>
Income tax expense (200 + 1,500)	(200)
Profit for the year	<hr/>
	250
	<hr/>
	14,740
	<hr/>
	(1,700)
	<hr/>
	13,040



WORKINGS

Motor vehicles

Cost	5,000
Acc. Dep.	(1,000)
	4,000
Dep. @ 20% red. bal.	
(0.2 x 4,000)	(800)
	3,200

Buildings

Cost	12,000
Acc. Dep.	(2,400)
	9,600
Dep. (12,000 / 25)	(480)
	9,120

 $PPE = 3,200 (MV) + 9,120 (L+B) = 12,320$ $Inventory = 2,500 + 500 + 1,000 = 4,000$ **Answer to example 2 – Statement of changes in equity (1)**

Answer C – Amortisation is an expense that is charged through the statement of profit and loss, it is not shown in the statement of comprehensive income.

Answer to example 3 – Statement of changes in equity (2)

	<i>Equity shares</i>	<i>Share premium</i>	<i>Retained earnings</i>	<i>Other components of equity</i>	<i>Total</i>
	<i>\$'000s</i>	<i>\$'000s</i>	<i>\$'000s</i>	<i>\$'000s</i>	<i>\$'000s</i>
B/f	400	50	310	165	925
Issue of share capital	200	50	-	-	250
Dividends	-	-	(98)	-	(98)
Total comprehensive income for the year	-	-	421	105	526
C/f	600	100	633	270	1,603



Chapter 4

Answer to example 1 – Statement of cash flows

Statement of cash flows for the year ended [date]

	\$'000s	\$'000s
Cash flows from operating activities		
Profit before tax	15,000	
Finance cost	400	
Investment income	(180)	
Depreciation	4,658	
Profit on disposal of PPE	(720)	
Decrease in inventory (3,560 - 9,635)	6,075	
Increase in receivables (6,405 - 4,542)	(1,863)	
Increase in payables (7,562 - 4,364)	<u>3,198</u>	
Cash generated from operations	26,568	
Interest paid	(400)	
Income taxes paid (W)	<u>(4,090)</u>	
 Net cash from operating activities	 22,078	
Cash flows from investing activities		
Purchase of property, plant and equipment (W)	(23,340)	
Proceeds from sale of property, plant and equipment (1,974 + 720)	2,694	
Dividends received	180	
 Net cash used in investing activities	 (20,466)	
Cash flows from financing activities		
Issue of equity shares	1,869	
Repayment of long-term borrowings	(2,300)	
Dividends paid (6,465 + 10,650 - 16,115)	<u>(1,000)</u>	
 Net cash used in financing activities	 (1,431)	
Net increase/(decrease) in cash and cash equivalents	181	
Cash and cash equivalents at beginning of period (1,063 - 429)	634	
Cash and cash equivalents at end of period (2,045 - 1,230)	<u>815</u>	



WORKINGS**Tax paid***Tax payable*

		B/f – current tax	2,760
Bank (β)	4,090	Tax expense (SPL)	4,350
C/f – current tax	3,020		
	<hr/> 7,110		<hr/> 7,110

Property, plant and equipment (PPE)*PPE (CV)*

B/f	26,574		
		Depreciation	4,658
Cash - additions (β)	23,340	Disposal	1,974
		C/f	43,282
	<hr/> 49,914		<hr/> 49,914



Chapter 5

Answer to example 1 – Revaluation increase

	<i>SFP</i>		<i>SPLOCI</i>
	\$'000		\$'000
Property, plant and equipment	89,412	Depreciation	5,588
Revaluation reserve	25,412	Gain	27,000
	<i>Historic cost</i> (\$'000)	<i>Revaluation model</i> (\$'000)	<i>Revaluation reserve</i> (\$'000)
Cost (1.1.12)	80,000		
Acc. Depn. (80,000/20) x 3 years	<u>(12,000)</u>		
Carrying value (31.12.14)	68,000	95,000	27,000
Depreciation (95,000/17)	<u>(4,000)</u>	<u>(5,588)</u>	<u>(1,588)</u>
	89,412		25,412

Answer to example 2 – Revaluation decrease

	<i>SFP</i>		<i>SPLOCI</i>
	\$'000		\$'000
Property, plant and equipment	8,000	Depreciation	1,750
		Impairment (PL)	400
		Impairment (OCI)	3,850
	<i>Historic cost</i> (\$'000)	<i>Revaluation model</i> (\$'000)	<i>Revaluation reserve</i> (\$'000)
Cost (1.1.13)	12,000		
Acc. Depn. (12,000/10) x 2 years	<u>(2,400)</u>		
Carrying value (31.12.14)	9,600	14,000	4,400
Depreciation (14,000/8)	<u>(1,200)</u>	<u>(1,750)</u>	<u>(550)</u>
Carrying value (before)	8,400	12,250	3,850
Impairment	<u>(400)</u>	<u>(4,250)</u>	<u>(3,850)</u>
Carrying value (after)		8,000	Nil



Answer to example 3 – Change in estimate

SFP	\$'000	SPLOCI	\$'000
Property, plant and equipment	14,000	Depreciation	3,500

	\$'000
Cost (1.1.12)	25,000
Acc. Dep. (25,000/10) x 3 years	(7,500)
Carrying value (31.12.14)	<u>17,500</u>
Depreciation 17,500/5	(3,500)
	<u>14,000</u>

Answer to example 4 – PPE and financial statements

SFP	\$'000	SPLOCI	\$'000
Land and buildings	44,400	Depreciation (3,000 + 2,600)	5,600
Plant and equipment	21,000		

Workings

Plant and equipment

	\$'000
Cost	58,500
Acc. depn. b/f	(34,500)
	<u>24,000</u>
Depreciation 24,000 x 12.5%	(3,000)
	<u>21,000</u>

Land and buildings

	Historic cost	Revaluation model	Revaluation reserve
	(\$'000)	(\$'000)	(\$'000)
Cost	55,000		
Acc. depn.	(20,000)		
Carrying value (1.10.13)	35,000	47,000	12,000
Depreciation (39,000/15)		(2,600)	
Carrying value (30.09.14)		44,400	

Answer to example 5 – Specific borrowings

$$\begin{aligned} \text{Borrowing costs} &= \$10 \text{ million} \times 5\% \times 9/12 \\ &= \$375,000 \end{aligned}$$



Answer to example 6 – General borrowings

	%	\$m	Ave.
4% bank loan	4%	25	1
3% bank loan	3%	40	1.2
		65	2.2

$$\text{Weighted average} = \frac{2.2}{65} \times 100\% \\ = 3.38\%$$

$$\text{Capitalised} = (\$10m \times 3.38\%) + (\$15m \times 3.38\% \times 6/12) \\ = \$0.59m$$

Answer to example 7 – Grants and depreciable assets

The property, plant and equipment will be capitalised on the statement of financial position as a non-current asset at its cost of \$10 million.

It will be depreciated over its 10 year useful life and therefore \$1 million of depreciation will be charged through profit or loss each year. The carrying value of the PPE will be reduced by the same amount each year.

The government grant is for a depreciable asset and so the \$2 million will be spread over the same life as the PPE.

As Tweddle has met the conditions for the grant the \$2 million will be recognised as deferred income on the statement of financial position.

It will be spread/amortised over 10 years and therefore \$0.2 million income will be shown in profit or loss each year, with the deferred income being reduced by the same amount each year.

Tweddle will also split the deferred income at the reporting date between current and non-current liabilities.

The statement of cash flows will show a payment to acquire PPE of \$10 million and grant income of \$2 million in investing activities.

The depreciation and amortisation of government grants are both non-cash items in profit or loss and will need adjusting in operating activities if using the indirect method.

Answer to example 8 – Investment property and change of use

Addlington will treat the property using IAS 16 for the first six-months of the year before applying IAS 40 once the change in use of the property took place.

The property will be depreciated for the first six-months of the year resulting in a depreciation expense through profit or loss of \$0.5 million (\$20 million/20 years x 6/12), thus reducing the carrying value to \$19.5 million (\$20 million - \$0.5 million).

The property is revalued to its fair value of \$21 million on 1 July 2015 under IAS 16, giving a gain through other comprehensive income of \$1.5 million (\$21 million - \$19.5 million).

The property is now classified as investment property and no longer depreciated.

It is revalued to a fair value of \$21.6 million at the reporting date with the gain of \$0.6 million going through profit or loss.



Chapter 6

Answer to example 1 – Intangibles (1)

A

- A Incorrect – Development expenditure is amortised over its useful economic life, if it has a finite life, otherwise annual impairments are required.
- B Correct – Development costs are recognised on the statement of financial position as an intangible non-current asset.
- C Incorrect – Research expenditure cannot be capitalised, and is expensed through profit or loss.

Answer to example 2 – Intangibles (2)

The purchase of the patent should be capitalised at \$15 million and amortised over its useful life.

The \$6 million spent on the investigative phase is essentially research and should be expensed through profit or loss as incurred.

The \$8 million subsequently spent after completion of the research phase is development expenditure and is capitalised as an intangible non-current asset on the statement of financial position.

It is not yet amortised as the project is not yet complete but an impairment review should be carried out to see if the asset has lost value.

The \$1.5 million spent on marketing and training should both be expensed through profit or loss immediately.

Answer to example 3 – Intangibles (3)

The initial investigation into the viability of the new drug is research and is expensed through profit or loss at \$40,000 per month. A total of \$240,000 (\$40,000 x 6 months) will be expensed from 1 February 20X5 to 1 August 20X5 (6 months).

The commercial viability of the new drug and subsequent costs constitute as development costs as probable future economic benefits can be identified and there is a market for the drug. The costs are capitalised as an intangible non-current asset on the statement of financial position. A total of \$200,000 (\$40,000 x 5 months) is capitalised from 1 August 20X5 to 31 December 20X5 (5 months).

The intangible is not amortised as it would have an indefinite life, so annual impairment reviews are performed instead, to see if the asset has fallen in value.

The finance director cannot revalue the intangible as there is no active market, however the discounted future cash flows would indicate that the intangible is not impaired.



Chapter 7

Answer to example 1 – Impairment

<i>SFP (extract)</i>		<i>SPLOCI(extract)</i>	
	\$		\$
Non-current assets			
PPE (W)	24,000	Depreciation (W)	5,000
		Impairment (W)	1,000

WORKINGS

$$\text{Annual depreciation} = \frac{\$50,000}{10 \text{ years}} = \$5,000 \text{ per annum}$$

$$\begin{aligned} \text{Carrying value @ 31 December 20X9} &= \$50,000 - (\$5,000 \times 5 \text{ years}) \\ &= \$25,000 \end{aligned}$$

$$\begin{aligned} \text{Fair value less costs to sell} &= \$24,000 \\ (\$26,000 - \$2,000) & \end{aligned}$$

$$\begin{aligned} \text{Value in use} &= \$5,000 \times 3,791 \\ &= \$18,995 \end{aligned}$$

$$\text{Recoverable amount (higher)} = \$24,000$$

$$\begin{aligned} \text{Impairment} &= \$25,000 - \$24,000 \\ &= \$1,000 \end{aligned}$$



Answer to example 2– Individual asset impairment

The carrying value of \$975,000 at 31 December 20X7 is impaired by \$375,000 and \$600,000 is recorded in the statement of financial position.

Of the \$375,000 impairment, \$325,000 is charged against the revaluation surplus as the asset was previously revalued, and the remaining \$50,000 is charged through profit or loss.

	<i>Historic cost</i> \$	<i>Revaluation model</i> \$	<i>Revaluation surplus</i> \$
Cost (1.1.X1)	1,000,000		
Acc. Depn =1,000,000/20 years x 5 years (X1 to X5)	(250,000)		
CV (31.12.X5)	750,000	1,125,000	375,000
Acc. Depn	(100,000)	(150,000)	(50,000)
CV (31.12.X7)	650,000	975,000	325,000
	(50,000)	(375,000)	(325,000)
CV (31.12.X7)		600,000	Nil

Answer to example 3 – CGU impairment

The plant and equipment is reduced in value to \$4 million (\$5.2 million - \$1.2 million) as it has been specifically impaired following the destruction by fire of some of the equipment.

The goodwill is then fully impaired and written down to a nil carrying value.

The patent is reduced in value to \$1.5 million

The remaining impairment is then \$3.1 million (\$17 million - \$9.8 million (recoverable amount of CGU) - \$1.2 million (plant & equipment) - \$2.4 million (goodwill) - \$0.5 million (patent)), which is spread pro-rate over the remaining assets. As the receivables and cash are held at their realisable values they will not be impaired and so the remaining impairment is fully allocated to the buildings.



Chapter 8

Answer to example 1 – Non-current assets held for sale and discontinued operations

<i>SFP (extract)</i>		<i>SPL(extract)</i>	
	\$		\$
Current assets			
NCA-HFS (W)	68,000	Depreciation (W)	11,000
		Impairment (W)	5,000

Workings

Annual depreciation = \$120,000 / 10 years = \$12,000 p.a.

Carrying value (30 November 20X4) = 120,000 – (12,000 x 3 years) – (12,000 x 11/12) = \$73,000

Fair value less costs to sell = 70,000 – 2,000 = \$68,000

NCA-HFS (lower) = \$68,000

Impairment = 73,000 – 68,000 = \$5,000

Answer to example 2 – Discontinued operations

31 December 2015

The operation is not being sold so cannot be classified as held for sale and neither is it a discontinued operation as it is still operating until 31 March 2016. Angola is firmly committed to the closure but it hasn't taken place and so is included in continuing operations. A disclosure in the notes can be made of the intention to close the operation in the following year.

31 December 2016

The operation is now classified as a discontinued operation as it has now ceased operating.

Answer to example 3 – Discontinued operations

Ruta Co Statement of Profit or Loss and Other Comprehensive Income for the year ended 31 December 2017

	\$000	\$000
	2017	2016
Revenue	640	480
Cost of sales	(260)	(215)
Gross Profit	380	265
Administrative expenses	(60)	(48)
Distribution costs	(87)	(56)
Profit from continuing operations	233	161
Discontinued operations	(3)	(1)
Profit for the year	230	160



Chapter 9

Answer to example 1 – Error

Profit or loss and other comprehensive income for the year ended 31 December 2009

	2009 \$'000	2008 \$'000
as restated		
Revenue	2,600	2,500
Costs and expenses	(1,400)	(1,700)
Profit for the year	1,200	800
Gain on revaluation of properties	300	–
Total comprehensive income	1,500	800

Statement of Financial Position as at 31 December, 2009

	2009 \$'000	2008 \$'000
as restated		
TNCA	2,300	1,500
Current assets	1,700	800
	4,000	2,300
\$1 Equity shares	600	600
Retained earnings	2,700	1,500
Revaluation reserve	300	–
	3,600	2,100
Current liabilities	400	200
	4,000	2,300

Statement of Changes in Equity for the year ended 31 December 2009

	Share capital \$'000	Revaluation reserve \$'000	Retained earnings \$'000	Total \$'000
Balance at 31 December, 2008	600	–	2,000	2,600
Material error	–	–	(500)	(500)
Restated balance	600	–	1,500	2,100
Surplus on revaluation of properties		300		300
Net Profit for the year			1,200	1,200
Balance at 31 December, 2009	600	300	2,700	3,600

Answer to example 2 – Accounting estimates

The change in method is a change in accounting estimate.

The changing of the capitalisation of finance costs is a change in accounting policy.



Answer to example 3 – Prior year error

The total receivables of \$3.4m should be removed from the statement of financial position in the current year.

\$1.0m should be recognised as an expense in the statement of profit or loss in the current year, through operating expenses.

The \$2.4m that relates to previous periods is a prior year error and should be recognised through the statement of changes in equity as an adjustment to the opening retained earnings.

Chapter 10

Answer to example 1 – Inventory (cost)

Answer B

Answer to example 2 – Inventory (valuation)

	\$/unit
Material cost	3
Labour cost	2
Overheads (=72,000/12,000)	6
Total cost	11

$$\text{NRV} = \$12 - \$2 = \$10$$

$$\text{Total inventory valuation} = (800 \text{ undamaged units} \times \$11) + (200 \text{ damaged units} \times \$10) = \$10,800$$

Chapter 11

Answer to example 1 – Financial assets

1. The investment in shares is initially recognised at \$500,000 on the statement of financial position as an asset.

The transaction costs are recognised immediately through profit or loss as the shares are classified as fair value through profit or loss.

At the reporting date the shares are re-measured to their fair value of \$350,000 on the statement of financial position.

A loss on the investment is recognised through profit or loss of \$150,000.

2. The investment in shares is initially recognised at \$540,000 on the statement of financial position as an asset.

The transaction costs are included in the value of the asset as it is held strategically for the long-term and therefore classified as fair value through other comprehensive income.

At the reporting date the shares are re-measured to fair value of \$620,000 on the statement of financial position.

The gain on the investment of \$80,000 is shown through other comprehensive income.

On disposal of the shares a gain of \$30,000 is recognised through profit or loss and the \$80,000 held in other comprehensive income is transferred to retained earnings through the statement of changes in equity as a reserve transfer.

3. The investment in debt is classified as amortised cost as there are contractual coupon interest receipts each year and the intent is to hold the asset until all the cash has been collected.

The investment in debt is initially measured at \$980,000 on the statement of financial position.



The effective rate of interest is used to calculate the interest income each year. In the first year the interest income is \$56,154 (\$980,000 x 5.73%) and is recognised through profit or loss.

The cash receipts of \$40,000 are used to reduce the value of the investment on the statement of financial position.

The investment in debt is held at \$996,451 at the reporting date on the statement of financial position.

Answer to example 2 – Financial liabilities

SPL

	Year 1	Year 2	Year 3	Year 4
Finance cost	87	89	91	93

SFP

	Year 1	Year 2	Year 3	Year 4
2% debentures (W)	1,947	1,996	2,047	-

Working

Year	B/f	Interest (4.58%)	Cash	C/f
1	1,900	87	(40)	1,947
2	1,947	89	(40)	1,996
3	1,996	91	(40)	2,047
4	2,047	93	(2,140)	-

Answer to example 3 – Convertible Debentures

Alice is required to account for the convertible debentures on initial recognition based on substance and using split equity accounting.

The liability is calculated on the assumption that there is no conversion option on the debt, so essentially treated as a 100% loan redeem for cash. The initial liability is recognised at the present value of the future cash flows, discounted at the rate of interest on similar debt without the conversion option.

This gives a figure of \$94.7 million (see working below).

The difference between the liability and the net proceeds is recognised within equity at \$5.3 million.

The subsequent accounting treatment of the debt is at amortised cost, whilst the equity balance is not adjusted until conversion takes place in the future.

Working

Year	Cash flow (\$m)	DF (@ 6%)	PV (\$m)
1	4 (4% coupon x \$100 million (par))	0.943	3.772
2	4	0.890	3.56
3	104 (\$4m plus \$100 million (par at redemption))	0.840	87.36
			94.692
			=\$94.7 million



Chapter 12

Answer to example 1 – Low-value assets

An expense of \$1,500 would be recognised through profit or loss for each of the four year lease. At the end of year one an accrual of \$1,500 would be recognised on the statement of financial position of which \$500 would be released over the remaining three years of the lease.

$$\text{Expense (p.a.)} = \frac{\$2,000 \times 3}{4} = \$1,500$$

Answer to example 2 – Lessee accounting

Initial recognition

Record the right of use asset and lease liability

DR Right-of-use asset \$22,730
CR Lease liability \$22,730

Record the initial direct costs

DR Right-of-use asset \$1,000
CR Cash \$1,000

Record the incentive payments received

DR Cash \$500
CR Right-of-use asset \$500

$$\text{Right-of-use asset} = 22,730 + 1,000 - 500 = 23,230$$

Subsequent measurement

Depreciate the asset over the earlier lease term of five years.

$$\text{Expense (p.a.)} = \frac{\$23,230}{5} = \$4,646$$

Record finance lease payments and interest using the rate implicit in the lease

Year	B/f	Payment	Capital balance	Finance cost (5%)	C/f
1	22,730	(5,000)	17,730	887	18,617
2	18,617	(5,000)	13,617	681	14,298
3	14,298	(5,000)	9,298	465	9,763
4	9,763	(5,000)	4,763	237	5,000
5	5,000	(5,000)	-	-	-



Answer to example 3 – Sale and leaseback (1)

(i) Transfer of asset is not a sale

Seller

- Continue to recognise the asset @ \$8.4 million and depreciate.
- Recognise a financial liability @ transfer proceeds of \$10 million.

Lessor

- Do not recognise the asset as it has not been sold to the buyer.
- Recognise a financial asset @ transfer proceeds of \$10 million.

(ii) Transfer of asset is sale

Seller

- Derecognise the asset @ \$8.4 million¹
- Recognise lease liability @ PV of lease rentals²
- Recognise a right-of-use asset, as a proportion of the previous carrying value of underlying asset³
- Gain/loss on rights transferred⁴

Lessor

- Recognise purchase of the asset @ \$10 million (fair value = proceeds)
- Apply lessor accounting

DR Bank	\$10,000,000
DR Right of use asset ³ (W2)	\$6,486,257
CR Lease liability ² (W1)	\$7,721,735
CR PPE – Building ¹	\$8,400,000
CR Gain on transfer ⁴	\$364,522

(W1) Lease liability = PV of lease rentals at rate implicit in the lease = \$1 million x AF_{1-10@5%}

$$\text{Lease a} = \$1 \text{ million} \times 7.722 = \$7,721,735$$

(W2)	\$	\$
Right-of-use retained	7,721,735	77.22%
Rights transferred	2,278,265	22.78%
Total	10,000,000	100.0%
		8,400,000



Answer to example 4 – Sale and leaseback (2)

i) The proceeds of \$9 million are below the \$10 million fair value of the asset and so the below-market proceeds of \$1 million are treated as a prepayment.

DR Bank	\$9,000,000
DR Prepayment	\$1,000,000
DR Right of use asset ³ (W2)	\$6,486,257
CR Lease liability ² (W1)	\$7,721,735
CR PPE – Building ¹	\$8,400,000
CR Gain on transfer ⁴	\$364,522

ii) The proceeds of \$11 million are greater than the \$10 million fair value of the asset, so the above market proceeds are treated as additional financing provided by the buyer-lessor to the seller-lessee.

DR Bank	\$11,000,000
DR Right of use asset ³ (W2)	\$6,486,257
CR Lease liability ² (W1)	\$8,721,735
CR PPE – Building ¹	\$8,400,000
CR Gain on transfer ⁴	\$364,522

Chapter 13

Answer to example 1 – Discounting and provisions

The provision is initially recognised at its present value on 1 July 2018 of \$450,000 ($= \$495,000 \times 0.9091$ (rounded to nearest \$000)).

The provision is then unwound at 10% for six months to calculate the finance cost of \$22,500 ($\$450,000 \times 10\% \times 6/12$)

SFP	SPL
\$	\$
Provision	472,500
Finance cost	22,500

Answer to example 2 – Provisions and contingencies (1)

Answer A

Answer to example 3 – Provisions and contingencies (2)

If she has a 42% chance of losing, then she must have a 58% chance of winning. It is, therefore, not probable that she has an obligation. No provision would be appropriate.

However, there is a possible obligation, arising from some past event, which may involve the outflow of economic resource.

The appropriate treatment in Justina's financial statements for the year ended 31 August, 2009 would therefore seem to be to treat the matter as a contingent liability.

This involves:

- a disclosure note of the past event,
- the legal action outstanding,
- an explanation of the uncertainties upon which the outcome depends, and
- an estimate of the costs, were she to lose the case



Answer to example 4 – Onerous contract

(a) Yes, a legal obligation under the purchase contract

(b) Give notice, and buy the cloth for 2 more months and produce	Give notice, buy the cloth, and sell immediately	Cancel the contract without notice
Cost $2 \times 900 \times \$7$	12,600	$2 \times 900 \times \$7$
Labour cost $2 \times 900/3 \times \$4$	2,400	
		15,000
Sell 2×300 dresses $\times \$22$	13,200	Sell $2 \times 900 \times \$6.25$
Loss	(1,800)	Loss
		(1,350)
		Loss
		(1,400)

There is therefore an unavoidable loss of \$1,350. This should be provided for in the Statement of Financial Position and expensed through the Statement of Profit or Loss and Other Comprehensive Income. In the Notes to the Financial Statements, there should be an explanation of the circumstances and the uncertainties concerning timings, amounts and assumptions

Answer to example 5 – Restructuring

(a) There is neither a legal nor constructive obligation, because no obligating event has yet occurred. The directors could change their minds, and decide to keep the Kaunas factory open. Therefore, no provision is appropriate.

(b) There is a detailed plan, the impact of which has been communicated to suppliers and the workforce. Paulius has therefore raised the valid expectation in the minds of those affected. Although not a legal obligation, there is a constructive obligation arising from some past event, involving the probable outflow of economic resource. A provision is therefore appropriate in the amount which represents the best estimate of the costs of closing the Kaunas factory.

Chapter 14

Answer to example 1 – Events after the reporting period

B

- The impairment indicator existed at the reporting date and the valuation gives additional evidence towards the impairment review, therefore an adjusting event
- The sale of inventory below cost provides additional evidence on the value of the inventory at the reporting date, therefore an adjusting event
- The fraud/error is an adjusting event as it will have been in evidence at the reporting date but not yet discovered, therefore an adjusting event.
- The insolvency of the customer gives evidence that they were in financial difficulty at the reporting date, therefore an adjusting event.

Answer 2– Events after the reporting period

Non-adjusting events as the issue of shares does not give evidence of a condition that existed at the year-end. The company would use the issue of shares in its calculation of basic EPS.

An adjusting event as the legal action and its outcome give evidence of a condition that existed at the reporting date. A provision of \$80,000 would be made.

An adjusting event that reduces the value of year-end inventory by \$10,000 as it gives evidence of the fall in value of the inventory held at the reporting date. Inventory included in the accounts at the year-end would now be included at \$15,000.



A non-adjusting event as the condition did not exist at the reporting date. As the item is material a disclosure of its nature and financial impact would be made in the notes.

Chapter 15

Answer to example 1 – Current tax

Statement of profit or loss for the year ended 31 March 2015 (extract)

	\$'000
Profit before tax	X
Income tax expense (3,500 – 400)	(3,100)
Profit for the year	X

Statement of financial position as at 31 March 2015 (extract)

	\$'000
Current liabilities	
Tax payable	3,500

Answer to example 2 – Tracy (ignoring deferred tax)

	20X5 (\$'000s)	20X6 (\$'000s)	20X7 (\$'000s)
Profit before tax	2,000	2,000	2,000
Income tax expense	(100)	(500)	(520)
Profit after tax	1,900	1,500	1,480

WORKINGS

	20X5 (\$'000s)	20X6 (\$'000s)	20X7 (\$'000s)
Profit before tax	2,000	2,000	2,000
Add: depreciation	1,000	1,000	1,000
Less: tax depreciation	(2,500)	(500)	(400)
PCTCT	500	2,500	2,600
Tax @ 20%	100	500	520

	\$'000s
Cost	5,000
Tax allowance X5 (50%)	(2,500)
	2,500
Tax allowance X6 (20%)	(500)
	2,000
Tax allowance X7 (20%)	(400)
	1,600



Answer to example 3 – Tracy (incl. deferred tax)

	20X5 (\$000s)	20X6 (\$000s)	20X7 (\$000s)
Profit before tax	2,000	2,000	2,000
Income tax expense			
- current tax	(100)	(500)	(520)
- deferred tax movement	(300)	100	120
Profit after tax	1,500	1,600	1,600

	20X5 (\$000s)	20X6 (\$000s)	20X7 (\$000s)
Carrying value	4,000	3,000	2,000
Tax base	2,500	2,000	1,600
Temporary difference	1,500	1,000	400
@ 20%	300	200	80
	DT liab	DT liab	DT liab
Closing DT	300	200	80
Opening DT	0	300	200
Movement	300	100	120
	increase	decrease	decrease

Answer to example 4 – Accelerated capital allowances

1. Calculate the temporary difference

	Year 1 \$	Year 2 \$	Year 3 \$
Carrying value	130,000	110,000	90,000
Tax base	112,500	84,375	63,281
Temporary difference	17,500	25,625	26,719

2. Calculate the deferred tax position

	Year 1 \$	Year 2 \$	Year 3 \$
Temporary difference	17,500	25,625	26,719
Deferred tax position @20%	3,500	5,125	5,344

3. Deferred tax asset/liability?

	Year 1 \$	Year 2 \$	Year 3 \$
CV > TB	CV > TB	CV > TB	CV > TB
DT Liability	DT Liability	DT Liability	DT Liability
	3,500	5,125	5,344



4. Movement in opening and closing position

	Year 1	Year 2	Year 3
	\$	\$	\$
Closing position	3,500	5,125	5,344
Opening position	Nil	3,500	5,125
Movement	3,500	1,625	219
	↑ Liability	↑ Liability	↑ Liability

Answer to example 5 – Revaluations

There is a gain on revaluation at the year-end of \$330,000 (\$800,000 - \$470,000) that is shown through other comprehensive income.

The deferred tax is calculated in the standard fashion but the carrying value is based upon the revalued amount.

	Year 1
	\$
Carrying value (revalued amount)	800,000
Tax base	420,000
Temporary difference	380,000
Deferred tax position @20%	76,000
	Liability
	(CV > TB)

The deferred tax liability must be recorded at \$76,000 at the end of the first year but careful consideration must be given to the movement in the deferred tax liability as it is higher than what it is expected to be given the asset was revalued.

DR	Profit or loss (β)	12,000
DR	Other comprehensive income (\$330,000 gain on revaluation x 20%)	66,000
CR	Deferred tax liability	76,000

Chapter 16

Answer to example 1 – Transaction price

The three-year interest-free credit period suggests that the \$10,000 selling price includes a significant financing component.

The selling price is therefore discounted to present value based on a discount rate that reflects the credit characteristics of the party (customer) receiving the financing i.e. 5%.

Therefore the transaction price is $\$10,000 / (1.05)^3 = \$10,000 \times 0.8638 = \$8,638$.

Answer to example 2 – Allocation of price

The performance obligations and allocation of total price are as follows:

Provision of home cinema system $(9,000 / 11,000 \times \$10,000) = \$8,182$

Provision of maintenance contract $(2,000 / 11,000 \times \$10,000) = \$1,818$



Answer to example 3 – IFRS 15 (1)

1. Identify the contract
 - Signed agreement
2. Identify the separate performance obligations
 - Sale of handset
 - Provision of calls and data service
3. Determine the transaction price
 - $\$540 = \$45 \times 12 \text{ months}$
4. Allocate transaction price to performance obligations
 - Standalone prices (using Vodafone)
 - $\$720 (= \$480 + (12 \text{ months} \times \$20))$
 - Handset = $480/720 \times 540 = \$360$
 - Calls and data = $240/720 \times 540 = \$180$
5. Recognise revenue as each performance obligation is satisfied
 - Handset (goods) = at
 - Calls and data (services) = over 12 months

Answer to example 4 – IFRS 15 (2)

1. Identify the contract
 - Signed agreement
2. Identify the separate performance obligations
 - Supply and installation service
 - Technical support
3. Determine the transaction price
 - Combined contract price = \$1,600
4. Allocate transaction price to performance obligations
 - Standalone price(supply and installation) = \$1,500
 - Standalone price (technical support) = \$500
 - Supply and installation = $1,500/2,000 \times 1,600 = \$1,200$
 - Technical support = $500/2,000 \times 540 = \$400$
5. Recognise revenue as each performance obligation is satisfied
 - Supply and installation = on installation (1 July 20X7)
 - Technical support = over two years (1 July 20X7 to 30 June 20X9)

<i>SFP (extract)</i>	<i>SPL (extract)</i>	
	\$	\$
Non-current liabilities		Revenue
Deferred income	100	$= 1,200 + (6/24 \times 400)$
Current liabilities		1,300
Deferred income	200	
	$= 12/24 \times 400$	



Answer 5 – Performance obligations over time and the statement of profit or loss (1)

	\$m
Revenue (= work certified in year)	15.0
Cost (β)	<u>(9.2)</u>
Profit (9.1 (W) – 3.3)	5.8

Workings

	\$m
Total revenue	45.0
Total costs (20.0 + 12.0)	<u>(32.0)</u>
Profit	13.0
	@ 70% 9.1

Answer 6 – Performance obligations over time and the statement of profit or loss (2)

	\$m
Revenue (45% x 40)	18.0
Cost (β)	<u>(23.0)</u>
Loss (100%)	(5.0)

Workings

	\$m
Total revenue	40.0
Total costs (25.0 + 20.0)	<u>(45.0)</u>
Loss	(5.0)

Answer 7 – Performance obligations over time and the statement of financial position

Statement of profit or loss (extract)

	\$000
Revenue (40% x 140,000)	56,000
Cost (β)	<u>(43,200)</u>
Profit	12,800

Statement of financial position (extract)

Current assets

	\$
Costs incurred to date	52,000
Recognised profits	12,800
Recognised losses	(–)
Progress billings to date	<u>(45,000)</u>
Gross amount due from/(to) customers	19,800

Receivables (45,000 – 26,500)	18,500
-------------------------------	--------



Workings

	\$000s
Total revenue	140,000
Total costs (60,000 + 48,000)	<u>(108,000)</u>
Profit	32,000
	@ 40% 12,800

Chapter 17**Answer to example 1 – Functional currency (1)**

1 December 2015

DR	Purchases	\$97,561
CR	Payables	\$97,561
=	$\frac{400,000 \text{ Dinar}}{4.1}$	\$97,561

31 December 2015

Retranslate the monetary balance (payable) at the closing rate (4.3 Dinar:\$1)

=	$\frac{400,000 \text{ Dinar}}{4.3}$	\$93,023
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Reduction in payables = \$97,561 - \$93,023 = \$4,538

DR	Payables	\$4,538
CR	Profit or loss	\$4,538

Do not retranslate the non-monetary balance (inventory), and leave it at \$97,561 at the reporting date.

10 January 2016

Translate the payment at the exchange rate on the day of the transaction

=	$\frac{400,000 \text{ Dinar}}{4.4}$	\$90,909
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DR	Payables	\$93,023
CR	Bank	\$90,909
CR	Profit or loss	\$2,114

Chapter 18**No examples in the chapter**

Chapter 19

Answer to example 1 – Basic EPS

a) Basic EPS = $\frac{250m}{500m} = 50c \text{ per share}$

b) Basic EPS = $\frac{250m}{546m \text{ (W)}} = 45.8c \text{ per share}$

Date	No. shares in issue	Weighting (# months)	Weighted average no. shares
1 July X5	500m	1/12	42m
1 August X5	550m	11/12	504m
WANS =			546m

New number of shares

Original number 500

New issue 50

New number 550

c) Basic EPS = $\frac{250m}{625m} = 40c \text{ per share}$

New number of shares

Original number 500

New issue 125

New number 625

d) Basic EPS = $\frac{250m}{546m} = 45.8c \text{ per share}$

Date	No. shares in issue	Weighting (# months)	Fraction	Weighted average no. shares
1 July X5	500m	7/12	1.40/1.38	296m
1 Feb X6	600m	5/12		250m
WANS =				546m

New number of shares

$500m \times 1 \div 8 = 63m$ extra shares

New number of shares = $500m + 63m = 563m$

Theoretical ex-rights price

	\$	\$
5 shares at	1.40	7.00
1 share at	1.25	1.25
<u>6 shares</u>		<u>8.25</u>

TERP = $8.25/6 = \$1.375$

Therefore rights issue fraction = $1.40 / 1.38$

Answer to example 2 – Multiple share issues and prior year comparatives

$$\text{EPS (31 March 2019)} = \frac{\$750,000}{5,250,000(\text{W})} = 14.29\text{c}$$

$$\text{EPS (31 March 2018 - restated)} = 15.5 \times 2/3 = 10.33\text{c}$$

(W)

Date	No. shares in issue	Weighting (# months)	Fraction	Weighted average no. shares
1.4.18 – 30.9.18	2,000,000	6/12	3/2	1,500,000
New issue	3,000,000			
1.10.18 – 30.11.18	5,000,000	2/12	3/2	1,250,000
Bonus issue	2,500,000			
1.12.18 – 31.3.19	7,500,000	4/12		2,500,000
			WANS =	5,250,000
Bonus fraction (1-for-2)	=	No. shares in issue after No. shares in issue after	=	$\frac{3}{2}$

Answer to example 3 – Diluted EPS

i) Convertible loan stock

$$\text{Diluted EPS} = \frac{500\text{m} + 400\text{k}}{1,000\text{m} + 12.5\text{m}} = 49.4\text{c per share}$$

(W1) Extra earnings = \$500,000 x (1 – 0.2) = \$400,000

(W2) Extra Shares = \$10m x 125 shares / \$100 = 12.5m

ii) Share options

$$\text{Diluted EPS} = \frac{500\text{m}}{1,000\text{m} + 37.5\text{m}} = 48.2\text{c per share}$$

No. shares under the option	100m
No. shares at full market value	62.5m
100 x \$2.50/\$4.00	37.5m

Fully diluted EPS

	Earnings (\$m)	Shares (m)	
Basic	500	1,000	
Options	-	37.5	
Convertibles	0.4	12.5	
	500.4	1,050	47.6c

Both the basic EPS of 50c and the fully diluted EPS of 47.6c are to be disclosed.



Chapter 20

Answer to example 1 – ROCE

ROCE = PBIT / Net debt + equity x 100%

ROCE = 10,200 / 35,600 + 6,900 x 100% = 24%

Answer B

Answer to example 2 – Financial performance

(a)

	2019	2018
Gross margin	54.8% (=23,000/42,000)	62.2% (=28,000/45,000)
Operating margin	31.0% (=13,000/42,000)	24.4% (=11,000/45,000)

(b) The revenue has fallen by 6.7% due to more customers shopping using the Internet. If the company does not do more to address the decline then it will run the risk of continued falling sales in future periods. It might be a future strategy to sell its goods via the Internet as well as from its high street stores.

Gross margin has fallen due to rising costs of production that have been unable to be passed on directly to its customers. This will have been done in order to maintain competitiveness with the online market, but if margins are to improve then Archer Co will need to either increase the selling prices or look to source the same products at more competitive prices.

Operating margin has increased because Archer Co has implemented a cost cutting exercise that will have reduced staff numbers, and/or closed down stores that were under-performing. This will have resulted in large costs of redundancy in the prior year that are not present in the current year costs, and lower wages/rent in the current year.

Finance costs have reduced as the funds received from the shareholders has been used to reduce the borrowing and lower the interest costs.



Chapter 21

Answer to example 1 – Working capital

Answer C – The liquidity position is worsening as the current ratio has fallen.

Answer to example 2 – Financial performance and working capital

The expansion of operations has resulted in more than a 50% increase in revenue, however this has been at the expense of gross profit margin which has reduced from 27.5% to 21.9%. This is a significant decrease in the period, however it is likely that this is as a result of a strategic decision to sell a lower margin product as costs would not be expected to increase that dramatically in a 6 month period. Alternatively, it could be the result of a strategic decision to sell the new product at a discount in order to boost the volume of sales.

There has been a significant increase in inventories held, increasing from 58 days to 92 days. This is not surprising in a period of expansion and it is most likely needed in order to meet the increased demand.

More concerning is the position on receivables and payables, as it appears that SAF is overtrading with an increase in receivable days from 72 to 101 days in the last six months. It could be as a result of more favourable credit terms being offered to new customers, however since receivables days have increased beyond payable days the result will be increased pressure on the entity's liquidity.

It could be the case that the credit control department has struggled to cope with the increased level of activity and could be addressed simply by dedicating additional resources to credit control.

The current ratio has fallen. However the quick ratio is more of a concern as it has decreased from 1.6 to 1.2 and this together with the entity having moved from a positive cash position to having short term borrowings, makes it clear that the expansion has caused problems with the management of working capital. The entity should ensure that an overdraft facility is in place until procedures can be imposed to improve the management of working capital.

Appendix

<i>All workings in \$000's</i>	<i>6 months to 31 December 20X2</i>	<i>6 months to 30 June 20X2</i>
Inventory days	$1,220/2,420 \times 182.5$ = 92 days	$460/1,450 \times 182.5$ = 58 days
Payable days	$1,190/2,420 \times 182.5$ = 90 days	$580/1,450 \times 182.5$ = 73 days
Receivable days	$1,715/3,100 \times 182.5$ = 101 days	$790/2,000 \times 182.5$ = 72 days
Current ratio	$2,935/1,440 = 2.0$	$1,400/580 = 2.4$
Quick ratio	$1,715/1,440 = 1.2$	$940/580 = 1.6$
Gross profit margin	$680/3,100 \times 100 = 21.9\%$	$550/2,000 \times 100 = 27.5\%$



Chapter 22

Answer to example 1 – Investor ratios

EPS 56.7c = Earnings/No. shares in issue = 22,680/40,000

Dividend cover 5.4 times = EPS/DPS = 56.6c/10.5c

Dividend yield 8.75% = DPS/Price per share = 10.5c/\$1.20 x 100%

P/E ratio 2.12 = Share price/EPS = \$1.20/56.6c

NOTE: No. shares in issue = \$20m/50c = 40m shares

Chapter 23

Answer to example 1 – Basic consolidation

	<i>Peter Group</i> \$000
Other assets (1,500 + 1,200)	2,700
<hr/>	
Total assets	2,700
<hr/>	
Equity share capital	1,000
Retained earnings	1,100
<hr/>	
Liabilities (400 + 200)	2,100
<hr/>	
Total equity and liabilities	600
<hr/>	
	2,700

Answer to example 2 – Basic consolidation (continued)

	<i>Peter Group</i> \$000
Other assets (1,900 + 1,450)	3,350
<hr/>	
Total assets	3,350
<hr/>	
Equity share capital	1,000
Retained earnings (=1,400 + (100% x (900 – 750)))	1,550
<hr/>	
Liabilities (500 + 300)	2,550
<hr/>	
Total equity and liabilities	800
<hr/>	
	3,350



Answer to example 3 – Non-controlling interest

	<i>Pierre Group</i>
	\$000
Other assets	3,350
(1,900 + 1,450)	
<hr/>	
Total assets	3,350
<hr/>	
Equity share capital	1,000
Retained earnings	1,320
(1,200 + (80% x (900 – 750)))	
<hr/>	
	2,320
Non-controlling interest	230
(25% x (250 + 750)) + (25% x (900 – 750))	
<hr/>	
	2,550
Liabilities	800
(500 + 300)	
<hr/>	
Total equity and liabilities	3,350
<hr/>	

Answer to example 4 – Goodwill

(i) Proportionate share of net assets method

	\$
FV of consideration	156,000
NCI at acquisition (25% x 170,000)	42,500
FV of net assets at acquisition	(170,000)
Goodwill at acquisition	<hr/> 28,500

(ii) Fair value method

	\$
FV of consideration	156,000
NCI at acquisition	52,000
FV of net assets at acquisition (W2)	(170,000)
Goodwill at acquisition	<hr/> 38,000



Answer to example 5 – Basic consolidation (revision)

(a) Goodwill

	\$	\$
Cost of investment		1,380,000
NCI at acquisition		450,000
Net assets		
Share capital	1,000,000	
Retained earnings	480,000	
		<u>(1,480,000)</u>
Goodwill		<u>350,000</u>

(b) Non-controlling interests

	\$
NCI at acquisition	450,000
NCI% of post-acquisition profits 25% x (660,000 – 480,000)	45,000
NCI at reporting date	<u>495,000</u>

(c) Other figures

- (i) Investment = **\$nil**
- (ii) Other assets = $4,500 + 2,400 = \mathbf{\$6,900,000}$
- (iii) Share capital = **\$2,000,000** (100% P only)
- (iv) Retained earnings = $2,040 + [75\% \times (660 - 480)] = \mathbf{\$2,175,000}$
- (v) Liabilities = $1,840 + 740 = \mathbf{\$2,580,000}$

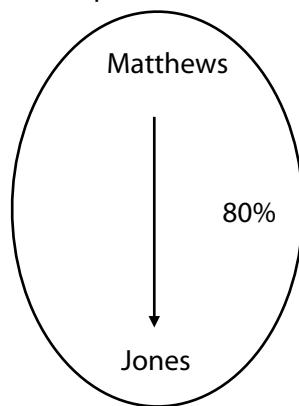


Answer to example 6 – Workings

	<i>Matthews Group \$000</i>
Non-current assets (1,000 + 500)	1,500
Goodwill (W3)	500
Current assets (800 + 600)	1,400
Total assets	<u>3,400</u>
Equity share capital (\$1)	500
Retained earnings (W5)	1,040
	<u>1,540</u>
Non-controlling interest (W4)	260
	<u>1,800</u>
Liabilities (1,100 + 500)	1,600
Total equity and liabilities	<u>3,400</u>

Workings

W1) Group Structure



W2) Net assets of subsidiary

	<i>At reporting date</i>	<i>At acquisition</i>	<i>Post acquisition</i>
Equity shares	200	200	
Ret. earnings	400	100	
	<u>600</u>	<u>300</u>	<u>300</u>

W3) Goodwill

FV of consideration (shares/cash)	600
NCI at acquisition (FV)	200
	<u>800</u>
FV of net assets at acquisition (W2)	(300)
Goodwill at acquisition	<u>500</u>



W4) Non-controlling interests

NCI @ acqn (W3)	200
Add: 20% x 300 (W2)	60
	260

W5) Group retained earnings

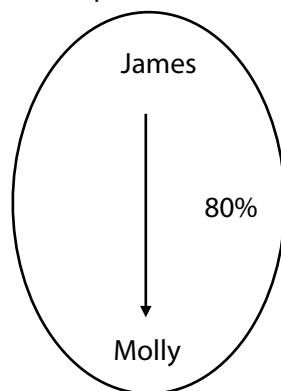
100% P	800
Add: 80% x 300 (W2)	240
	1,040

Answer to example 7 – Unrealised profits

	<i>James</i> <i>Group</i> \$'000
Non-current assets	
PPE (900 + 500)	1,400
Goodwill (W3)	650
Current Assets (700 + 600 – 10 (PUP))	1,290
	<hr/> 3,340
Share Capital	500
Retained earnings (W5)	992
Non-controlling interest (W4)	248
Current liabilities (1,100 + 500)	1,600
	<hr/> 3,340

WORKINGS

W1) Group Structure



W2) Net assets of subsidiary

	At reporting date	At acquisition	Post acquisition
Equity shares	200	200	
Ret. earnings	400	150	
PUP (20/120 x 120 x 1/2)	(10)		
	590	350	240

W3) Goodwill

FV of consideration (shares/cash)	800
NCI at acquisition (FV)	200
	1,000
FV of net assets at acquisition (W2)	(350)
Goodwill at acquisition	650

W4) Non-controlling interests

NCI @ acqn (W3)	200
Add: 20% x 240 (W2)	48
	248

W5) Group retained earnings

100% P	800
Add: 80% x 240 (W2)	192
	992

Answer to example 8 – Share exchange

1. No. S shares acquired = $80\% \times 10,000,000 = 8,000,000$
2. No. P shares issued = $8,000,000 \times 1/4 = 2,000,000$
3. Value of P shares issued = $2,000,000 \times \$3 = \$6,000,000$ (cost of investment)
4. Journal entry

Dr Investment	\$6,000,000
Cr Share capital	\$2,000,000
Cr Share premium (β)	\$4,000,000

Answer to example 9 – Deferred consideration

Share exchange

1. No. S shares acquired = $80\% \times 30,000,000 = 24,000,000$
2. No. P shares issued = $24,000,000 \times 2/3 = 16,000,000$
3. Value of P shares issued = $16,000,000 \times \$2 = \$32,000,000$ (cost of investment)

Deferred consideration

PV of consideration = $24,000,000 \times \$1 \times 0.91 = 21,840,000$

Total consideration

= $32,000,000 + 21,840,000 = \$53,840,000$



Chapter 24

Answer to example 1 – Basic consolidation (revision)

	<i>Group</i>
	<i>\$'000</i>
Revenue	11,600
(8,400 + 3,200)	
Cost of sales	(6,300)
(4,600 + 1,700)	
Gross profit	5,300
Operating expenses	(2,160)
(2,200 + 960)	
Profit before tax	3,140
Taxation	(740)
(600 + 140)	
Profit for the year	2,400
Profit attributable to:	
Equity shareholders (β)	2,320
Non-controlling interest	80
(20% x 400)	

Answer to example 2 – Basic consolidation (mid-year acquisition)

	P	S	<i>Vader</i>
			<i>\$'000</i>
Revenue			2,285
(1,645 + (6/12 x 1,280))			
Cost of sales			(1,700)
(1,205 + (6/12 x 990))			
Gross profit			585
Distribution costs			(135)
(100 + (6/12 x 70))			
Administrative expenses			(135)
(90 + (6/12 x 50) + 20(imp))			
Profit before interest and tax			315
Finance costs			(70)
(55 x (6/12 x 30))			
Investment income			2
(10 – (80% x 10))			
Profit before tax			247
Taxation			(49)
(35 + (6/12 x 28))			
Profit for the year			198

Profit attributable to:

Equity shareholders (β)	190.8
Non-controlling interest	7.2

= 20% x [(6/12 x 112) – 20]



Answer to example 3 – Unrealised profits

	P	S	Adj.	Group
Revenue	120,000	90,000	(10,000)	200,000
COS	(70,000)	(40,000)	10,000	(100,500)
PUP		(500)		
(25/125 x 10,000 x 1/4)				
Gross profit				99,500
Op exp.	(20,000)	(35,000)		(56,000)
-Impairment		(1,000)		
Finance cost	(2,000)	(500)		(2,500)
Profit before tax				41,000
Taxation	(6,000)	(3,000)		(9,000)
PFY		10,000		32,000
		Parent (β)		30,000
		NCI = 20% x 10,000		2,000

Answer to example 4 – Group disposals

	\$m
Proceeds	200
Add: non-controlling interest	15
Less: net assets at disposal	(150)
Less: goodwill	(38)
Group profit on disposal	27

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Answer to example 1 – Associate

	\$
Cost of investment in A	250,000
Add: 30% x 170,000	51,000
Less: impairment of goodwill	(20,000)
	281,000



